UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

	§	**Chapter 11**
In re:	§	
	§	**Case No. 02-15533 (AJG)**
WORLDCOM, INC., et al.,	§	
	§	**Jointly Administered**
Debtors.	§	
	§	

SECOND INTERIM REPORT OF DICK THORNBURGH, BANKRUPTCY COURT EXAMINER

June 9, 2003

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I. INTRODUCTION

On November 4, 2002, Dick Thornburgh, the Bankruptcy Court Examiner, filed his First Interim Report in accordance with the 90-day time period set forth in the Order approving his appointment, dated August 6, 2002. That Order provided that the Examiner "shall investigate any allegations of fraud, dishonesty, incompetence, mismanagement or irregularity in the management of the affairs of [WorldCom, Inc. and its affiliates] by current or former management, including but not limited to issues of accounting irregularities." At the time of the appointment of the Examiner, WorldCom had announced, on June 25, 2002, a restatement of its financial statements totaling approximately $3.8 billion regarding line costs capitalization. This was followed in August 2002 by another restatement of approximately $3.3 billion, which included $2.3 billion of reserve releases principally related to line costs reclassification adjustments.

As noted in the Court's August 6, 2002 Order, the scope of the Examiner's work is not limited to accounting irregularities. In the First Interim Report, there is only a short discussion of the accounting irregularities in deference to the sensitivity of the various governmental investigations and prosecutions related to these matters. The First Interim Report includes preliminary observations regarding a number of other non-accounting issues that raise significant questions concerning the conduct of WorldCom Management and concludes that it is not possible for the Examiner to complete his investigation in the initial time period prescribed by the Court.

Since the filing of the First Interim Report, the Examiner and his professionals have aggressively continued their investigation.[1] In light of the ongoing governmental investigations and prosecutions regarding the WorldCom accounting issues, the Examiner has focused his investigation on other areas to avoid duplication of effort and in continued deference to those prosecutorial and regulatory efforts. This Second Interim Report includes additional findings of the Examiner in certain of these other areas. Given the number and complexity of these other issues and the challenges in obtaining relevant information promptly, it has not been possible for the Examiner to complete his investigation. Thus, the Examiner is continuing his investigation in many of the areas referenced.

Although this Second Interim Report will not repeat matters contained in the First Interim Report, it is instructive to review briefly the preliminary conclusions of that Report. The First Interim Report stated that "[o]ur preliminary observations reflect cause for substantial concern regarding the Company's past practices, particularly with respect to the reasonableness and integrity of its accounting and financial reporting functions and related oversight by persons within the Company, the Board of Directors and the independent auditors of WorldCom. Our investigation strongly suggests that WorldCom personnel responded to changing business conditions and earnings pressures by taking extraordinary and illegal steps to mask the discrepancy between the financial reality at the Company and Wall Street's expectations."

This Second Interim Report builds and expands upon the Examiner's observations, primarily regarding the non-accounting issues included in the First Interim Report. As discussed more fully below, the Examiner has identified a growing number of troubling and problematic issues. Although the economic magnitude of these other issues may not approach the dollar

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1 As noted in the First Interim Report, the Examiner retained Kirkpatrick & Lockhart LLP as his counsel and J. H. Cohen LLP as his forensic accountants and financial advisors.

amount of the previously identified accounting irregularities, they closely resemble them in their egregiousness, arrogance and brazenness. These deficiencies reflect a virtual complete breakdown of proper corporate governance principles, making WorldCom the poster child for corporate governance failures. Every level of “gatekeeper” that had the responsibility to promote and ensure proper corporate governance was derelict in its duties to some degree. Compounding the problem, a culture existed at WorldCom in which many who were aware of acts of wrongdoing and neglect stood silently by and took no steps to object. As a result, Management and the Board took numerous actions, or failed to take appropriate actions, that hurt WorldCom's shareholders, employees and creditors, and contributed to WorldCom’s rapid downfall.

This Second Interim Report focuses most closely on corporate governance issues. "Corporate governance" is a term that is subject to multiple definitions. For purposes of this Second Interim Report, the Examiner defines "corporate governance" as the system by which WorldCom was managed and controlled, the means by which WorldCom determined its objectives and performance, and the methods by which it promoted transparency and accountability. In short, corporate governance refers to the processes designed to protect the various constituencies of WorldCom, including its shareholders, employees and creditors. The Examiner believes that at least some of WorldCom's corporate governance failures are present in many other public companies and that there are important lessons to be learned from the WorldCom story.

II. PROCESS OF EXAMINATION

Consistent with the Court’s initial directive to the Examiner, we have continued to coordinate our efforts extensively with those of various federal agencies or offices examining matters related to WorldCom and its present or former personnel, including the United States

Department of Justice, the United States Attorney for the Southern District of New York and the United States Securities and Exchange Commission ("SEC"), in an effort to promote efficiency and avoid duplication of effort. We also have communicated and coordinated our efforts with the Honorable Richard C. Breeden, the Corporate Monitor appointed by the United States District Court for the Southern District of New York in connection with charges filed against WorldCom by the SEC, and with the Special Investigative Committee of the Company's Board of Directors and its professionals, which conducted their own inquiry regarding certain matters reviewed by the Examiner. The Examiner acknowledges with appreciation the considerable assistance provided by these other parties, their counsel and other professionals.

As stated in the First Interim Report, the initial 90-day examination period prescribed by the Court allowed the Examiner and his professionals to conduct only a preliminary review of various matters related to the conduct of WorldCom Management, WorldCom's Board of Directors and outside service providers. Since the filing of the First Interim Report, we have significantly intensified our investigative efforts to advance the preliminary observations set forth in that Report. To ensure that we continue to avoid duplicating the efforts of others who are investigating and prosecuting matters related to the financial fraud, and to provide the Court and the public with a broader examination of WorldCom, we have primarily focused our efforts in this Second Interim Report on issues that are not the principal subjects of other investigations.

In support of these efforts, we have collected and reviewed millions of additional documents and records. We also have conducted dozens of additional interviews of present or former WorldCom officers, Directors and employees, as well as third parties, in an effort to develop further the underlying facts. These interviews provided valuable information that was not always available in the documents and records, and thus we relied heavily on them. To the extent appropriate, we have directly quoted from interviews with witnesses to explain and underscore certain observations.[2]

With respect to the restatement process relating to the Company's financial statements for the periods ending December 31, 1999 through March 31, 2002, we have reviewed closely the process undertaken by the Company, with the assistance of its current outside auditors, KPMG LLP ("KPMG"), to identify and correct all material misstatements. Attorneys and forensic accountants engaged by the Examiner have identified for WorldCom and KPMG items for analysis and possible restatement based upon our examination.

Since the filing of the First Interim Report, WorldCom and its counsel have provided us with a substantial amount of additional documents and information. In addition, the Company and its counsel have been extremely helpful in arranging for interviews of numerous witnesses, some on relatively short notice. The Examiner acknowledges and appreciates this extensive cooperation by the Company and its counsel.

Further, although we are continuing to endeavor to explore fully the matters outlined by the Court in its August 6, 2002 Order, it should be noted that our efforts to date, and our ability to report with respect to our findings, have been limited by time constraints and certain other circumstances. First, as described below, it has not been possible to identify, gather and review completely certain relevant data in the time since the Examiner was appointed. Accordingly, some of the findings set forth in this Report should continue to be regarded as preliminary.

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[2] The Examiner received documents and information from both in-house and outside counsel to WorldCom. Pursuant to this Court's Order of September 23, 2002, WorldCom was required to produce to the Examiner all documents and other information requested. That Order also provided that disclosure to the Examiner of documents or information that may be protected by the attorney-client privilege or any other privilege or protection held by WorldCom did not constitute a waiver of any privilege or protection. Similarly, disclosure of any document or information in this Second Interim Report should not be viewed as a waiver of any applicable privilege or protection by the Company.

Second, it is significant that we have not yet been able to interview certain people with knowledge and information that is highly relevant to our investigation. Most significantly, we have not had the opportunity to interview Bernard Ebbers and Scott Sullivan, the former Chief Executive Officer and the former Chief Financial Officer of WorldCom, respectively. Quite aside from the widely reported accounting irregularities, these individuals were central figures in other areas that are the subject of the Examiner's investigation. In addition, government investigators have asked us not to interview certain persons who may be witnesses in the various prosecutions and we have honored those requests. Finally, scheduling conflicts and other issues have prevented us from interviewing certain persons in advance of this Second Interim Report. Many additional interviews are already scheduled and we hope to complete them in the near future.

The Examiner acknowledges the cooperation he has received from the large number of persons who voluntarily agreed to interviews, some of which lasted several days. The Examiner has not been forced thus far to resort to any subpoenas in carrying out his work. In the interview process and in assessing corporate governance issues, the Examiner necessarily has needed to make judgments about credibility. In general, the Examiner believes that the persons interviewed have sought to be credible. However, the Examiner also believes that some persons, in seeking to justify actions taken and not taken, and responsibilities not assumed, may view past conduct with a certain lack of objectivity. That is probably inevitable. As a consequence, however, the Examiner has found it all the more important to seek to sort through and make judgments concerning sometimes contradictory versions of the "story" so that the facts and conduct are accurately understood.

III. SUMMARY OF OBSERVATIONS

The WorldCom story is not limited to the massive accounting fraud that has been publicly reported. Aside from these issues, the Examiner's continued investigation into other matters has uncovered additional deceit, deficiencies and a disregard for the most basic principles of corporate governance.

The Examiner has identified significant problems with respect to virtually every area reviewed, including acquisitions, strategic planning, debt management, credit facilities, loans to Mr. Ebbers, Mr. Ebbers' $70 million forward sale, employee compensation, and internal controls. The observations of the Examiner regarding these matters, which are detailed in later sections of this Report, may be summarized as follows:

- WorldCom was dominated by Messrs. Ebbers and Sullivan, with virtually no checks or restraints placed on their actions by the Board of Directors or other Management. Significantly, although many present or former officers and Directors of WorldCom told us they had misgivings regarding decisions or actions by Mr. Ebbers or Mr. Sullivan during the relevant period, there is no evidence that these officers and Directors made any attempts to curb, stop or challenge the conduct by Mr. Ebbers or Mr. Sullivan that they deemed questionable or inappropriate. Instead, it appears that the Company's officers and Directors went along with Mr. Ebbers and Mr. Sullivan, even under circumstances that suggested corporate actions were at best imprudent, and at worst inappropriate and fraudulent.

- The Company's approach to acquisitions and significant outsourcing transactions was *ad hoc* and opportunistic. Our examination has revealed little meaningful or coherent strategic planning at WorldCom. Further, in many instances, the Company's decision-making was marked by a striking absence of proper corporate governance protocols.

- WorldCom Management provided the Company's Directors with extremely limited information regarding many acquisition transactions. Several multi-billion dollar acquisitions were approved by the Board of Directors following discussions that lasted for 30 minutes or less and without the Directors receiving a single piece of paper regarding the terms or implications of the transactions.

- The process surrounding the Company's decision to acquire Intermedia Communications, Inc. ("Intermedia") in September 2000 is particularly troubling.

In what one former Director described an “ego deal” for Mr. Ebbers, WorldCom responded to a perceived threat that a competitor could acquire Intermedia (or Digex, Inc. ("Digex"), a Web hosting company controlled by Intermedia) by agreeing to pay $6 billion for the company, based upon approximately 60-90 minutes of due diligence and a 35-minute telephonic Board meeting for which some Directors received no more than two hours notice. The facts raise substantial doubt concerning Management's basis for recommending the transaction and the adequacy of the information provided to the Board. As a former Director stated, “God himself could not have made the decision in one day.” The Directors were not provided with any written materials or analyses concerning this potential transaction. Although numerous people involved with the Board’s consideration of the Intermedia transaction now state that they were disturbed by the deal at the time, no Director or anyone else voiced any objection to the cursory consideration by the Board.

- The concerns related to the Intermedia acquisition become even more acute when viewed in the light of subsequent developments. Shortly after the acquisition agreement was announced on September 5, 2000, minority shareholders of Digex filed a lawsuit challenging the transaction. This litigation, and the declining value of other Intermedia assets, gave WorldCom an opportunity to abandon the proposed acquisition. Rather than do so, WorldCom Management, at the apparent direction of Mr. Ebbers, and without consulting the Board of Directors, entered into an agreement to settle the Digex shareholder litigation and signed an amended merger agreement with Intermedia in February 2001. Although a February 15, 2001 WorldCom press release stated that the Board had approved the settlement, the Company’s outside Directors were not even polled at the time with respect to whether they wanted to continue with the transaction. In March 2001, the Board passively adopted and endorsed the prior acts of Management, without objection. All told, the acquisition of Intermedia was a dismal failure, producing massive losses for WorldCom. The Examiner believes that a vigilant Board of Directors would have rejected Management's actions.

- Another troubling transaction is WorldCom’s $2 billion acquisition of SkyTel Communications, Inc. ("SkyTel") in 1999. That transaction, which was of questionable strategic benefit to WorldCom, was approved by the Board after a presentation by Management lasting about 15 minutes and, again, without a single piece of paper being provided to the Board. The Board members interviewed by the Examiner did not appear troubled by this lack of consideration because the acquisition was for “only” $2 billion. The Examiner believes that a transaction of that magnitude deserved far greater consideration and deliberation.

- The Examiner also has substantial questions concerning the process by which WorldCom adopted its Tracker stock structure in November 2000. Our investigation identified little evidence of a thoughtful strategic plan for the Tracker stocks. Instead, it appears that, as stated by one former WorldCom Director, the Tracker stocks were merely the “flavor of the month.”

- The Examiner also has concerns regarding the allocation of assets, debt and expenses between the WorldCom Group and the MCI Group under the Tracker stock structure. The Examiner is investigating whether these allocations were intended to burden disproportionately the MCI Group businesses and what the effect of such allocations may be on inter-company claims and creditors.

- The Examiner is also concerned about the Company's tendency to utilize its debt offerings and credit facilities to further a practice pursuant to which it paid off existing investors or lenders with newly-borrowed funds, while growing its debt to a level that became ultimately unserviceable. WorldCom's ability to borrow monies was facilitated by its massive accounting fraud, as it allowed the Company to falsely present itself as creditworthy and "investment grade," when in fact its debt was below "investment grade."

- There is no evidence of meaningful debt planning by WorldCom. Indeed, there is no evidence that Company Management or the Board reasonably monitored the Company's debt level or its ability to satisfy its outstanding obligations. A prime example of inadequate planning was the Company's use of the proceeds from a massive $11.9 billion debt offering in May 2001, which WorldCom projected would satisfy its cash needs for the ensuing 18 months. In fact, WorldCom spent the proceeds in about eight months.

- Messrs. Ebbers and Sullivan had virtually unfettered discretion to commit the Company to billions of dollars in debt obligations with virtually no meaningful Board oversight. WorldCom issued more than $25 billion in debt securities in the four years preceding its bankruptcy. With respect to such offerings, Messrs. Ebbers and Sullivan comprised the entirety of the Company's Pricing Committee. The Board passively "rubber-stamped" proposals from Messrs. Ebbers or Sullivan regarding additional borrowings, most often via unanimous consent resolutions that were adopted after little or no discussion.

- The Company's drawdown on a $2.65 billion line of credit in May 2002 raises significant issues. Despite public statements by Mr. Sullivan early in May 2002 that "certainly there is liquidity in the Company . . . we're in a very solid situation," the evidence establishes that WorldCom had a desperate need for cash at the time. The Company had to meet several large payment obligations and its debt had been downgraded. Moreover, Mr. Sullivan said that "the "money [from the credit facility] won't be used for anything. The money will be sitting on the balance sheet in cash; it will be invested for a few weeks" and repaid when WorldCom completed a $5 billion secured financing in June 2002. However, it appears that at the time Mr. Sullivan made those statements, WorldCom already had decided to use a portion of the proceeds from the line of credit to make payments with respect to the Company's accounts receivable credit program. As the Company's Treasurer told us in an interview, WorldCom merely "robbed Peter to pay Paul."

- The facts and circumstances surrounding the Company's loans of more than $400 million to Mr. Ebbers raise additional and very serious corporate governance concerns. The Compensation and Stock Option Committee of the Board of Directors (the "Compensation Committee") agreed to provide enormous loans and a guaranty for Mr. Ebbers without initially informing the full Board or taking appropriate steps to protect the Company. As the loans and guaranty increased, the Compensation Committee failed to perform appropriate due diligence that would have demonstrated that the collateral was insufficient to support the credit extended to Mr. Ebbers, in light of his substantial other loans and obligations. The Board was similarly at fault for not raising any questions about the loans and merely rubber stamping the actions of the Compensation Committee.

- A forward sale of three million WorldCom shares by Mr. Ebbers in September 2000, in which he received proceeds of over $70 million, also raises questions. Mr. Ebbers had a strong and widely known opposition to any WorldCom employee selling stock of the Company. In early September 2000, Mr. Ebbers received the first of his loans from WorldCom, for $50 million, because the Compensation Committee did not want him to make good on his threat to sell any of his WorldCom stock to meet margin obligations. At this same time, the Compensation Committee also awarded Mr. Ebbers a $10 million cash retention bonus. These amounts were apparently not enough, as Mr. Ebbers asked the Compensation Committee for an additional loan in late September 2000. When the Compensation Committee refused his request, Mr. Ebbers entered into a forward sale of three million shares of WorldCom stock and received a payment of over $70 million. Coincidentally or not, the price of WorldCom stock dropped $2.25 a share on October 4, 2000, the day after the public announcement of the forward sale. Instead of taking reasonable measures to protect WorldCom and its shareholders from Mr. Ebbers' deteriorating personal finances, the Compensation Committee later that month magnified the problem by providing a $75 million guaranty and an additional $25 million loan to Mr. Ebbers. Ultimately, the loans to Mr. Ebbers reached over $400 million.

- The timing and circumstances of the forward sale are also problematic in other respects. Specifically, WorldCom received legal advice from outside counsel for WorldCom that the proposed sale might be inappropriate, particularly since it was to occur shortly before a negative earnings announcement. Despite this, the Company permitted the sale by Mr. Ebbers without adequately investigating the likelihood that the sale violated insider trading laws and despite the fact that the sale violated a Company policy that prohibited such transactions near the time of an earnings announcement.

- The Ebbers loans, guaranty and forward sale of stock are troubling for an additional reason. These fundings revealed the extent of Mr. Ebbers' business activities that were not related to WorldCom. The Board should have questioned these extensive non-WorldCom business activities as inconsistent with the need for Mr. Ebbers to devote his time and attention to managing the business of a large and complex company such as WorldCom. The need for Mr. Ebbers to devote his full attention to WorldCom matters became even more urgent when the downturn in the telecommunications industry began in 2000. The Board, however, did nothing to attempt to persuade Mr. Ebbers to divest himself of these non-WorldCom businesses or otherwise limit his non-WorldCom business activities. To the contrary, the Compensation Committee and the Board provided massive funding that facilitated Mr. Ebbers' personal business activities.

- The Examiner is continuing to review the process by which salaries, bonuses, stock options and other compensation were determined at WorldCom. Our investigation has revealed that there was a significant disparity between the way compensation matters were supposed to be handled in theory, and how they were actually handled. Despite public pronouncements to the contrary, Mr. Ebbers dominated compensation decisions. He was, for example, given almost complete discretion to authorize and allocate a $240 million retention bonus program in 2000 that involved large, up-front cash payments to over 500 executives. Mr. Ebbers awarded Mr. Sullivan and himself $10 million cash bonuses under this program, notwithstanding the fact that they had received retention bonuses of $7.5 million and $1.85 million, respectively, one year earlier, and notwithstanding that other company executives received a combination of cash and stock as retention bonuses.

- Mr. Sullivan paid part of his $10 million cash bonus to some of his subordinates, many of whom had received large retention bonuses directly from the Company. Mr. Sullivan gave $10,000 personal checks to at least seven employees, and additional $10,000 personal checks to the spouses of several of these employees. Although the Examiner has not identified any information linking these payments to illegal conduct, four of the individuals who received these payments have pled guilty to criminal fraud charges relating to the Company's accounting practices.

- The fact that WorldCom’s accounting irregularities went undetected for so long attests to substantial problems with the Company’s internal controls. The Audit Committee of the Board of Directors and the Internal Audit Department appear to have acted in good faith and, to their considerable credit, they took significant and responsible steps once accounting irregularities were discovered in the spring of 2002. However, it seems clear that the Audit Committee over the years barely scratched the surface of any potential accounting or financial reporting issues. Moreover, the Internal Audit Department adopted an operational audit function, rather than acting as WorldCom’s “internal control police.” Finally, it appears that the Audit Committee, the Internal Audit Department and Arthur Andersen allowed their missions to be limited and shaped in ways that served to conceal and perpetuate the Company's accounting fraud.

- The Examiner is troubled by several of his preliminary observations regarding the “risk based” audits Arthur Andersen performed during the relevant period. Although Arthur Andersen considered WorldCom to be a “maximum risk” client, it appears that it designed the WorldCom audits to accommodate primarily the needs and desires of the Company’s senior Management to the detriment of its own performance. The conduct of Arthur Andersen raises significant questions regarding its audit plan and communication with Management and the Audit Committee.

- WorldCom prepared MonRev reports, which identified the revenue of the Company on a monthly and quarterly basis. The Examiner is aware that "Special MonRev" reports were prepared for, and provided to, Arthur Andersen in the third and fourth quarters of 2001. These "Special" MonRev reports contained manipulated data that masked the amounts of certain “corporate adjustments, affecting revenues” and were different than the actual MonRev reports relied on by the Company.

- Accordingly, the Examiner has identified numerous occasions – on acquisitions, debt offerings, loans to Mr. Ebbers and other matters – on which the WorldCom Board was not adequately informed about significant corporate matters before giving its approval. The Examiner is troubled that no WorldCom attorneys (including in-house and outside counsel) appear to have believed that it was their responsibility to advise the Board of their fiduciary obligations to become adequately informed, even in instances where it seems likely that the Board lacked sufficient information. The Examiner recognizes that the WorldCom culture was not generally supportive of a strong legal function, but this should not have prevented counsel from fulfilling their obligations to their corporate client.

- All told, the Examiner believes that WorldCom's conferral of practically unlimited discretion upon Messrs. Ebbers and Sullivan, combined with passive acceptance of Management’s proposals by the Board of Directors, and a culture that diminished the importance of internal checks, forward-looking planning and meaningful debate or analysis formed the basis for the Company’s descent into bankruptcy.

As set forth above and in the remainder of this Second Interim Report, there are many persons and entities that share responsibility for WorldCom’s downfall and the losses suffered by the Company’s shareholders and creditors. While the degree of responsibility varies greatly, WorldCom could not have failed as a result of the actions of a limited number of individuals. Rather, there was a broad breakdown of the system of internal controls, corporate governance and individual responsibility, all of which worked together to create a culture in which few persons took responsibility until it was too late.

The Examiner understands that stepping forward to raise questions, whether it be on questionable accounting, lack of data provided to the Board of Directors, or other issues, would have involved acts of courage – possibly risking jobs in some instances. The Examiner further understands that WorldCom's most senior Management, especially Mr. Ebbers and Mr. Sullivan, enjoyed enormous power and substantial respect at various times, making the decision to take a stand that much more difficult. Nevertheless, the Examiner is disappointed that those with the responsibility to protect shareholders did not act sooner.

This Second Interim Report identifies a plethora of troubling and problematic matters. However, it should not be read as telling the entire or final story. Unfortunately, the Examiner believes that the extent of the breakdowns at WorldCom will eventually be determined to extend even beyond the Examiner's findings and observations that follow.

IV. ACQUISITIONS AND STRATEGIC PLANNING

A. Overview

In our First Interim Report, we provided a brief overview of WorldCom's growth from a small reseller of long distance services to a global telecommunications giant, fueled in material part by numerous acquisitions in the telecommunications field. As we observed in the Report, a distinguishing characteristic of WorldCom "was that it was constantly and feverishly in 'deal mode.'"[3] While that Report included several general observations, the Examiner did not have an opportunity at the time to review any transactions in detail.

Since the submission of the First Interim Report, the Examiner has investigated in greater depth various WorldCom acquisitions to assess its acquisition processes and related strategic planning, particularly from mid-1997 through June 2002. Prior to 1997, WorldCom acquisitions were relatively small transactions, with the exception of the $12 billion acquisition of MFS Communications Company, Inc. ("MFS") in late 1996. In the five-year period beginning in mid-

[3] In fact, the name of Mr. Ebbers' yacht, Aquasitions, combined his passions for power boats (discussed later in this Report) and acquisitions.

1997 and ending in mid-2002, WorldCom embarked on numerous acquisitions and outsourcing transactions totaling more than $50 billion, through which WorldCom catapulted into its leadership position as a provider of local and long distance telecommunications services and enabled it to expand further into wireless, international, data and Web services. The Company's acquisition included its $40 billion merger with MCI, several smaller acquisitions of providers of wireless or other telecommunications services, and a contemplated, but unsuccessful acquisition of Sprint, which would have been the largest merger in history. These acquisitions dramatically increased WorldCom's revenues, which produced a dramatic escalation in its stock price from under $20 per share to over $60 per share.

The Examiner's central focus in this area has been on the following issues:

- Whether WorldCom's Board of Directors and Management fulfilled their fiduciary responsibilities to shape corporate strategy in the best interests of the Company's shareholders and to act in good faith, without self-interest and on the basis of adequate information, in undertaking acquisitions that frequently involved multibillion dollar commitments by WorldCom;

- Whether WorldCom's Board of Directors and Management followed acceptable corporate governance practices with regard to strategic planning and acquisitions;

- Whether there were actions that WorldCom's Board reasonably could have been expected to take that would have improved its decision-making processes with respect to the Company's mergers and acquisitions and, as a result, might have affected the Board's decisions to approve transactions that ultimately proved inadvisable;

- In those instances in which the Examiner finds that actions or omissions by WorldCom's Board and/or Management were not consistent with fully satisfying their fiduciary responsibilities, whether such conduct adversely affected the interests of WorldCom's shareholders or creditors;

- Whether WorldCom's Board and Management undertook reasonable efforts to integrate WorldCom's various acquisitions so that the Company would achieve predicted synergies and cost savings;

- Whether WorldCom's Board properly authorized the creation of the Tracker stocks, which WorldCom announced on November 1, 2000;

- Whether the allocation of WorldCom's assets, liabilities, revenues and expenses between the WorldCom Group and the MCI Group Tracker stocks, was proper; and

- Whether WorldCom's accounting practices in connection with acquisitions, including the valuation of acquired assets and the creation and release of acquisition reserves, followed proper accounting practices.

The Examiner has made a determined effort to assess the conduct of the Board, Management and outside service providers (counsel, investment bankers and accountants) from the perspective of what reasonably could be expected of them at the time the conduct occurred, without the benefit of hindsight. Further, the Examiner believes that it is important to consider these issues in the context of the overall dynamics of the telecommunications industry during the relevant timeframe. Accordingly, conduct that might be viewed as sufficient to fulfill fiduciary responsibilities in 1997 and 1998, when WorldCom and the telecommunications industry were booming, may not have been satisfactory or sufficient in later years, when the telecommunications market entered into a deep decline and WorldCom's own financial performance suffered.

The Examiner stresses that many of his findings in this Chapter are preliminary. The various investigations of WorldCom since the first announcement of accounting irregularities in June 2002, have focused little attention on issues pertaining to WorldCom's acquisitions and strategic planning. Accordingly, in contrast to other areas of concern (such as WorldCom's accounting irregularities or Mr. Ebbers' loans) where the Examiner has benefited significantly from the work of others, the Examiner's pursuit of acquisition issues has largely plowed new ground. Moreover, the investigation has been impeded by the lack of opportunity to interview WorldCom's chief acquisition strategists: Messrs. Ebbers and Sullivan.

One additional preliminary comment is appropriate. The Examiner views the strategic planning and acquisitions area and the Tracker stocks as good windows on the entire issue of overall corporate governance at WorldCom, particularly during the period from 1997 through 2002. The issues identified in this area appear to be symptomatic of the corporate governance failures found throughout the Company.

B. Fiduciary Obligations of the Board and Management in an Acquisitions Context

Much has been written about the fiduciary obligations of boards of directors and senior management. E.g., Drexler, Black & Sparks, Delaware Corporate Law and Practice, Ch. 17, "The Proper Exercise of a Director's Responsibilities" (2002).[4] We do not intend to discuss the nature and scope of those responsibilities in detail in this Second Interim Report. However, given WorldCom's numerous acquisitions during the 1990s and 2000-01, the Examiner believes that it is important to evaluate whether WorldCom's Board and Management fulfilled the most basic responsibilities of boards of directors and senior management in the context of mergers and acquisitions, as well as in the context of related strategic planning.

Georgia law places the responsibility for managing the overall policies and direction of a company upon the board of directors. Ga. Code Ann. § 14-2-801 (2003). In carrying out this responsibility, statutory and judicial authorities impose three primary fiduciary duties upon the board of directors and management in their dealings with the company and its shareholders: the duties of care, loyalty, and good faith.

[4] The Examiner cites primarily to Delaware corporate law authorities, because they are more numerous than authorities on the Georgia corporate law governing WorldCom. On issues addressed in this Chapter, Delaware corporate law is not materially different from Georgia corporate law.

1. Duty of Care

"Directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them . . . [and then to] act with requisite care in the discharge of their duties." See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), overruled in part on other grounds, Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000); accord Matter of Munford, Inc., 98 F.3d 604, 611 (11th Cir. 1996), cert. denied, 522 U.S. 1068 (1998) (Georgia law).[5] Access to and consideration of adequate information is fundamental to rational business decision making.

In Aronson, the directors were charged with a breach of fiduciary duty. In determining whether the directors satisfied their fiduciary duties, the court primarily examined whether the directors took time to inform themselves of the facts and circumstances (such as price and other material terms) surrounding the transaction, evaluated alternative transactions, and sought the advice of counsel. In satisfying their duty to be informed, directors typically may rely in good faith on members of the company's management team and retained advisors, such as investment bankers, lawyers and accountants, who comprise the acquisition team, to conduct due diligence, evaluate issues affecting the advisability of pursuing the transaction and report their findings. See Delaware General Corporation Law, Del. Code Ann. § 141(e) ("DGCL"); Ga. Code Ann. § 14-2-830 (2003). Although fairness opinions are not strictly required, boards of directors often obtain them from financial advisers to support their decision making in material transactions. Notwithstanding their reliance on advisors, directors cannot delegate their fundamental duty of care to management or an advisor. See ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 103 (Del. Ch. 1999).

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[5] See Ga. Code Ann. § 14-2-830 (2003) (general standards for directors); id. § 14-2-842 (general standards for officers).

As a general matter, if a board has met its duty of care, decisions made by the board with respect to corporate actions will be protected from judicial scrutiny by the "business judgment rule," which provides that board actions enjoy a presumption of soundness and will not be disturbed if the Board acted independently, had an opportunity to exercise an informal judgment and their actions can be attributed to a rational corporate purpose. See Roger S. Aaron, Counseling Directors in the M&A Context, in Contests for Corporate Control, PLI No. B0-0180 (2002).

2. Duty of Loyalty

The duty of loyalty requires directors to act in good faith and not to allow their personal interests to prevail over the best interests of the company and its shareholders. Directors must be both independent and disinterested and refrain from conduct such as self-dealing, self-promotion and actions that serve to "entrench" them in office. See Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985). In fulfilling their duty of loyalty, directors must disclose to their fellow board members and stockholders any material facts surrounding the directors' interest in a particular transaction. See DGCL § 144(e). To be disinterested, directors must not obtain personal benefit from a transaction, other than a benefit enjoyed by all shareholders of the company, nor can directors be on both sides of the transaction. To be independent, a director must consider a transaction based on "corporate merits of the subject . . . rather than extraneous considerations or influences." See Aronson. v. Lewis, supra, 473 A.2d at 816. A director's personal interest in a transaction will result in a breach of such director's duty of loyalty only to the extent that such interest is material. A majority of the board must be disinterested and independent with respect to a transaction in order for courts to apply the business judgment rule. See Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1168 (Del. 1995).

3. Duty of Good Faith

Directors must act "in good faith, and in the honest belief that the action taken was in the best interest of the company" and its shareholders. See Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989). Bad faith on the part of a director requires more than bad judgment or neglect. Rather, bad faith involves actions that a director takes, or neglects to take, for an improper purpose, such as self-enrichment. A claim of bad faith "hinges on a party's tortious state of mind." Aronson v. Lewis, supra, 473 A.2d at 812.

4. Application of Responsibilities to WorldCom

The Examiner has not uncovered information that would indicate that Management and the Directors breached their duties of loyalty and good faith with respect to WorldCom's mergers, acquisitions, and outsourcing transactions. Whether Management and the Directors consistently met their obligations with respect to the duty of care, however, is a different matter.

The Examiner has substantial doubt whether WorldCom's Directors adequately informed themselves regarding certain material acquisitions pursued by Management, especially from 1999 onward. In order to establish the context for the Examiner's preliminary conclusions, we identify corporate governance practices that companies often take to ensure that the board and management fulfill their duty of care.

a. Strategic Planning and Acquisition Strategy

Acquisitions involve substantial risk and historically have yielded both significant rewards and catastrophic results for acquiring companies. Further, the acquisition process can consume substantial time and corporate resources. Accordingly, many companies establish acquisition policies and procedures to reduce risk exposure, maximize efficiency and ensure that best practices are implemented to evaluate potential acquisitions and integrate closed transactions.[6] Such policies and procedures also assist a company to ensure that acquisitions are consistent with the company's overall corporate strategy, that the board is well informed about the prospective target, including the key terms and material risks involved in the transaction, that at least one senior executive within the company is assigned to become familiar with the terms of the transaction and will spearhead integration of the target into the company post-closing and that the company has complied with applicable state and federal laws and regulations.[7] Adopting an acquisition strategy and related policies and procedures also can assist a company in assessing the long-term goals of its business and whether a particular transaction can best help to achieve those goals. Part of developing a mature strategy is implementing a process for considering and evaluating alternative corporate transactions, such as joint ventures, licensing and outsourcing transactions, that can help a company achieve certain corporate goals without incurring the costs and risks of acquisitions.[8]

b. Identifying and Considering Targets

Identifying and evaluating potential acquisition targets and determining how a particular acquisition target can help the company reach short-term or long-term goals are important components of an acquisition strategy. Specific considerations include the goal to be accomplished by the transaction, strategic capabilities of a target, acceptable size of a target, profitability requirements of a target, acceptable levels of risk exposure for the company resulting from an acquisition, resources required to complete the transaction, regulatory issues,

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6 See generally Diane Harris, *Behind the Boardroom Doors with Acquisition Decisions*, Director's Monthly (Nat. Assoc. Corp. Directors) May 2002.

7 Id.

8 Id.

acquisition capabilities of the acquiring company and organizational fit between the acquiring company and the target.[9]

c. Use of Corporate Development Groups and Special Committees

Often a corporate development group, senior executive, or sub-committee of the board is charged with the responsibility to administer a company's acquisition policies and procedures. The acquisition policies and procedures should cover the manner and type of potential transactions brought to management's attention, how transaction discussions may be initiated, how the transaction can be structured, who will review, negotiate and execute agreements, and when and how the board will be informed of prospective transactions.[10] To maintain consistency in the acquisition process, the delegation of authority may include standard procedures for transaction review, including compliance with GAAP and SEC regulations, valuation methodology, financing documents, deal-related fee arrangements, corporate policies regarding share dilution, and what benefits, if any, management can receive in the transaction. Companies often use a special committee of directors to evaluate acquisition opportunities and identify and analyze issues in large or particularly complex transactions.[11]

d. Due Diligence

Management, both through use of the company's personnel and through investment bankers, outside attorneys and accountants, will usually perform due diligence on a possible transaction to identify information that could affect the transaction's terms and price and, ultimately, the decision whether to pursue the transaction. Management typically focuses on

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9 See Robert F. Bruner, *Searching for Acquisitions: Some Guiding Principles*, Darden Grad. Sch. of Bus. Admin., Univ. of Va. Case No. UVA-F-1295SSRF (2000).

10 See generally Harris, supra.

11 See Edward D. Herlihy, *Takeover Law and Practice 2001*, in CONTESTS FOR CORPORATE CONTROL, PLI No. B0-00ZH (2001).

business due diligence issues, including matters affecting the target's industry and standing within the industry, the target's management team, material aspects of the target's business and the target's financial performance. The board of directors and management also frequently rely upon outside accountants to review a target company's financial information, as well as the analysis and fairness opinions of investment bankers, to help determine whether the proposed acquisition price is fair. Legal and accounting due diligence efforts usually include a review of publicly available background information on the target, board minutes, regulatory filings, corporate formation and good standing issues, outstanding capitalization, indebtedness, environmental issues, real and intellectual property, subsidiary operations, insurance, accounting and tax issues, management compensation, employee benefits and employee relations, and litigation and contingent liabilities.

e. Board Review

Although the board typically relies on management and outside advisers to perform due diligence, the board cannot delegate its duty of care. Accordingly, the board must make sufficient inquiries of the acquisition team and review information compiled by it to fulfill its fiduciary duties in connection with a given acquisition.

As a threshold matter, boards often consider whether a particular transaction is consistent with the company's general corporate strategy. Thereafter, relevant board inquiry primarily focuses on what, if any, material facts, such as material liabilities or weaknesses, were discovered in the due diligence process, whether a transaction will have a positive financial impact on the company on a short-term and long-term basis, and whether the terms of the transaction are fair and in the best interests of the company.

A board of directors that actively oversees management's decision-making process and seeks to inform itself of all of the factors relevant to a proposed transaction generally is protected by the business judgment rule. See Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1153-54 (Del. 1990). Courts will examine a number of factors to determine whether the board has adequately informed itself about a transaction. These factors include frequency and length of board meetings, board meeting attendance, whether management provided the board in a timely manner with information concerning the transaction, board requests for additional information, inquiries by the board regarding key elements of the transaction and use of legal and financial advisers to assist in the diligence process. See Drexler, Black & Sparks, supra § 15.06. In this regard, it is important that management bring a potential transaction to the board's attention sooner rather than later, so that the board has sufficient opportunity to inform itself and to ask management questions about the transaction before the transaction has gained so much momentum that it becomes inevitable. The timing, quality and nature of information presented to the board with respect to a potential transaction are critical to the board's ability to meet its duty of care and to provide a meaningful review of the transaction.

The following is an excerpt from Justice Horsey's opinion in the seminal duty of care case, Smith v. Van Gorkom, supra, which provides a stark example of a board that breached its duty of care:

> Without any documents before them concerning the proposed transaction, the members of the Board were required to rely entirely upon Van Gorkom's 20-minute oral presentation of the proposal. No written summary of the terms of the merger was presented; the directors were given no documentation to support the adequacy of $55 price per share for sale of the Company; and the Board had before it nothing more than Van Gorkom's statement of his understanding of the substance of an agreement which he admittedly had never read, nor which any member of the Board had ever seen.

As we discuss later in this Chapter, the factual description in Smith v. Van Gorkom is disturbingly similar to certain conduct of WorldCom's Board, which approved several multibillion dollar transactions in 15-35 minute meetings and without any supporting documentation. The Examiner doubts that any board could have become adequately informed under these circumstances.

C. WorldCom Strategic Planning and Acquisitions

1. Introduction

The Examiner's analysis of WorldCom's acquisitions from 1997 through mid-2002 involves three intertwined inquiries: (1) the degree to which the WorldCom Board and Management engaged in strategic planning; (2) whether the WorldCom Board and Management fulfilled their fiduciary duty to the Company's shareholders to become adequately informed before making significant business decisions; and (3) how well the various acquisitions were integrated so that contemplated synergies and cost savings could be achieved.

WorldCom grew to become a telecommunications giant mainly as a result of its numerous acquisitions during the 1990s. In light of those many acquisitions, the Examiner would have expected WorldCom to have had a focused strategic plan for, and approach to, acquisitions that took into account the complexity of a proposed transaction, how it would better position WorldCom, and how to achieve synergies and cost savings. The Examiner's investigation has shown no such reasonable planning or detailed consideration regarding these matters.

a. Management's Control of Strategic Planning and the Acquisitions Process

To the extent that strategic planning occurred in the 1997-2002 time period, the impetus came from Management, particularly Messrs. Ebbers and Sullivan and to a lesser extent

Mr. Sidgmore. The Board seemed content to delegate this important function to Management.[12] The Board formed no strategic planning committee. Within Management, a de facto Management group consisting mainly of Messrs. Ebbers, Sullivan and Sidgmore considered strategy matters.

Similarly, Management, to the exclusion of the Board, exercised virtually total control of WorldCom's acquisition processes. Management decided whether and when an acquisition would be brought to the Board for approval. The Board's role in the Company's acquisition processes appears to have been completely passive. For example, the Board established no guidelines (such as dollar thresholds or degree of complexity) for when WorldCom would retain an investment adviser or obtain a fairness opinion[13] in connection with a transaction. Indeed, Management made all decisions as to when to retain investment bankers, and which investment bankers to retain, in connection with transactions. One Director stated that he would have liked to have had a fairness opinion on any transaction in the $2 billion range or higher, but this clearly was not WorldCom's policy. In fact, among the six multi-billion dollar transactions that closed in the 1997-2001 period, a fairness opinion was obtained only with respect to the MCI transaction.

Similarly, the WorldCom Board often did not inquire into the amount of due diligence that Management or outside advisers conducted in connection with even quite large acquisitions. For instance, as discussed in greater detail below, on the Intermedia transaction, no Director

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12 One Director disagreed and said that "strategy was an ongoing discussion," "was front and center in our minds" and that the Board understood that strategic planning was one of its most important functions. Other Directors and members of Management did not support this assertion.

13 A fairness opinion is an opinion issued by an outside financial adviser to the effect that the price being paid by the acquiring company as received by the acquisition target was fair. Companies frequently seek fairness opinions as part of the process by which management and the board of directors become informed of all relevant facts.

made any inquiry of Management at the September 1, 2000 or March 1, 2001 Board meetings about the extent of due diligence performed in connection with the initial merger agreement or the subsequent amendment to that agreement. This lack of inquiry by the Board is all the more surprising given that Management apparently never provided the Board with a single document pertaining to this $6 billion transaction.

b. Ad Hoc Strategic Planning, But Some Reasonable Due Diligence

To the extent that Management pursued strategic planning, it was mostly *ad hoc* and opportunistic, with the Board, once again, playing a passive role. Although certain documents, denominated “strategic plans,” were created by Management in 1997 and 1999, these documents do not appear to be actual strategic plans. Rather, they appear to be financial analyses of WorldCom over a period of years, making projections of how WorldCom would grow if it pursued no further acquisitions. The Examiner has identified no evidence that the Board was shown, or that the Board or Management adopted, either plan.[14] Similarly, each filing by WorldCom on Form 10-K during the relevant period had a section entitled “strategy.” However, these descriptions of WorldCom’s “strategy” did not reflect any deliberations of the WorldCom Board or any planning group within Management.

Although WorldCom did not pursue “mega” deals, such as the MCI Communications Corporation ("MCI") and Sprint Corporation ("Sprint") acquisitions, as part of a carefully

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[14] One Director believes that the Board may have seen a summary of the 1997-2002 plan. The Examiner has been unable to confirm whether this was the case. Further, Mr. Sidgmore believes that Management did have a strategic plan – although this plan was not as formalized as the strategic plans of other companies – and that the plan concerned WorldCom’s business focus from 1997 onward on the data, Internet, wireless and international areas. The Examiner does not doubt Mr. Sidgmore’s belief that Management had such a plan (at least from 1997 through 1999) and that Messrs. Ebbers and Sullivan generally supported it. However, as discussed in this Chapter, the facts and circumstances surrounding many of the transactions pursued by the Company, undercut the notion that WorldCom Management pursued a focused acquisitions strategy.

considered strategic plan formulated with input from the Board, our investigation suggests that the Company approached these deals in a reasonably systematic manner. WorldCom Management engaged outside financial and legal advisers, and the Board received detailed presentations from investment bankers and law firms about the transactions, supported by documentary data. Moreover, WorldCom Management appears for the most part to have implemented adequate due diligence procedures with respect to acquisition targets. In the case of the "mega" transactions, WorldCom's investment bankers and outside legal counsel mainly were responsible for the due diligence process. On smaller transactions, such as the CompuServe/AOL/ANS, Electronic Data Systems, Inc. ("EDS") and SkyTel transactions, for which WorldCom engaged no outside financial advisers, the WorldCom Corporate Development Department, supported by personnel from other departments, would carry out due diligence. Based upon review of the available evidence, the Examiner believes that, with the exception of the Intermedia transaction, WorldCom Management and/or outside advisers conducted a reasonable amount of due diligence on both "mega" and smaller transactions, prior to asking the Board to approve a transaction. The Board's approach to due diligence procedures, however, was as passive as its approach to strategic planning. The Board established no guidelines for the performance of due diligence, how due diligence was to be memorialized or whether the Board was to be presented with due diligence data or summaries of such data.

c. Secretive Strategic Planning and Diminishing Data Provided to the Board on Acquisitions

Management's approach to strategic planning not only was *ad hoc* and opportunistic, it also was quite secretive. The Corporate Development Department, for example, would often prepare models to assess how well an acquired company would fit within WorldCom. The Corporate Development Department could not access WorldCom's internal financial data for these purposes and, instead, would use WorldCom data published by investment bankers. Further, senior Management (particularly Messrs. Ebbers, Sullivan and Sidgmore) did little to coordinate the efforts of various departments within the Company in identifying acquisition targets. The Corporate Development Department, for example, had very little role in the EDS transaction or a contemplated Web hosting joint venture with Andersen Consulting, both of which were headed up by Mr. Sidgmore.

The Corporate Development Department, which theoretically had the job of proposing, analyzing, and pursuing acquisitions, mainly depended upon Messrs. Ebbers and Sullivan to identify specific targets, or at least business areas, for it to research and analyze. Personnel in the Corporate Development Department had the impression that Mr. Ebbers felt that a Company-wide strategic plan would be a waste of time and money.

In the context of acquisitions-related strategic planning, the Examiner has further sought to assess the competence of those persons tasked with responsibility to decide whether to bring particular acquisitions to the Board for approval. Mr. Ebbers was described as shrewd and Mr. Sullivan was described as very capable at picking out acquisition targets. The Board, therefore, tended to have quite a lot of confidence in their judgment when they proposed a particular acquisition. The Examiner can understand such confidence during the 1990s, when WorldCom seemed to be highly successful and the market recognized that success. The Examiner finds it much harder to understand such deference in 2000 and 2001, when WorldCom's performance was much less satisfactory and the value of the Company's stock was declining.

The Examiner also has sought to determine whether sufficient numbers of adequately trained persons were available to carry out due diligence on acquisition targets and to plan for and implement integration. In this regard, there was no Corporate Development Department at all until 1995 and that Department never consisted of more than about 10 persons. The comparable department at MCI was much larger, but after the 1998 MCI closing, most members of the MCI planning department were let go, most likely reflecting Mr. Ebbers' apparent disdain for strategic planning. Further, the members of the WorldCom Corporate Development Department did not appear in most instances to be trained on planning issues. One member of Management characterized the Department's leadership as "some of Bernie's old buds." The small size of the WorldCom Corporate Development Department put a constant strain on resources and was one of the reasons that there was no standard means of memorializing due diligence – there was just no time, as the Department's personnel were too busy going from one potential deal to the next.

The Examiner sought to assess the reliability of certain of the tools used by WorldCom to assess the feasibility of acquisitions. The Examiner has determined that the Corporate Development Department developed a model to predict how WorldCom and an acquired company might perform if combined. That model was never rigorously tested by any non-interested party to determine whether it was reliable. Indeed, the Corporate Development Department was never the subject of a single audit by the Company's Internal Audit Department to determine, for example, whether appropriate types of due diligence were being undertaken.

WorldCom Management's secrecy and the lack of coordination in strategic planning parallel Management's tendency, over the period examined, to provide the Board with less and less data regarding a proposed acquisition in advance of or at Board meetings. With the exception of the MCI merger and the proposed transaction with Sprint, the quantity of written data and analyses that Management provided to the Board to support particular transactions continually decreased until it vanished altogether. As one Director observed, information provided only on the date of a Board vote was received too late to be meaningful. Moreover, the Examiner believes that the Board never received or requested a single page of paper that might serve to justify the $2.4 billion dollar transaction involving Brooks Fiber Properties, Inc. ("Brooks Fiber") in 1997-1998, the multi-billion dollar EDS and SkyTel transactions that occurred in 1999 and the $6 billion Intermedia transaction that occurred in 2000-2001. Rather, the Board listened to Management's brief presentations (30 minutes on Brooks Fiber, 20 minutes on EDS, 15 minutes on SkyTel and 35 minutes on Intermedia) and then approved each deal. The Examiner finds it difficult to understand how the Board could have satisfied its obligation to become informed when Management provided it with so little information and the Board spent so little time considering the information that it did receive.

The Examiner finds the Board's passive acceptance of Management's opportunistic, *ad hoc*, and secretive strategic planning, together with Management's tendency to provide the Board with little information concerning proposed transactions, particularly difficult to understand in 2000 and 2001, when WorldCom's financial performance was deteriorating. The Examiner would have expected that the WorldCom Board would have required Management to engage, and would itself have participated, in careful strategic planning and would have demanded even greater justification for transactions than in the earlier years, when WorldCom's business was flourishing. Just the opposite occurred: WorldCom's strategic planning remained haphazard; Management provided less and less information concerning transactions; and the Board never complained, even after the Company's loans to Mr. Ebbers caused many Directors to lose confidence in him.

2. Strategic Planning and Fiduciary Obligations in the Context of Specific Acquisitions

The foregoing general observations can best be illustrated by a review of the actual strategic planning in which WorldCom engaged, and the actual due diligence and approval processes that Management and the Board followed, with respect to particular transactions. This review proceeds chronologically, beginning with some small transactions in May 1997 and continuing through the Intermedia transaction, which closed on July 1, 2001 and which was WorldCom's last large transaction.

a. Strategic Planning and Acquisition Processes for Increasingly Complex Transactions: January 1997 through September 1998

At the end of 1996, WorldCom closed its acquisition of MFS - the largest transaction to date for WorldCom. The purchase price of MFS was approximately $12.5 billion, and MFS brought to WorldCom a diverse set of assets, including an Internet division (UUNET), significant local network facilities, and an international network. One Director believes that, in the wake of this transaction, Mr. Ebbers became "too successful" and "lost focus" due to WorldCom's growth in size.

Between January 1997 and early September 1997, Management and the Board appear to have undertaken little joint strategic planning. This apparent lack of strategic planning may be understandable, given the need to attempt to integrate MFS into WorldCom's existing business. At the Board level, strategic discussions, including those concerning potential acquisitions, were typically conducted during executive sessions held at the end of Board meetings. We can find no indication in the Board meeting minutes and other data that any executive sessions were held between January 1, 1997 and September 11, 1997. This suggests that, at the Board level, there were no extensive discussions of any strategic plan extending one or more years into the future.

b. The May 22, 1997 Acquisitions

At the May 22, 1997 WorldCom Board meeting, Management asked the Board to approve a series of modest divestitures, investments and acquisitions. A week prior to the meeting, Management sent each Board member a Board package that contained, among other things, a short description of each transaction, including its structure and rationale. The transactions had a total estimated value of $221 million.

The Examiner believes that the process Management followed to prepare the Board for the May 22, 1997 meeting was in accord with proper corporate practices. Management did its homework on the transactions and provided meaningful data to the Board in advance of the Board meeting so that Board members would be prepared to raise questions concerning the transactions at the meeting.

c. CompuServe/AOL/ANS[15]

During the period from January 1997 through September 1997, individual members of Management focused on some matters of strategic importance. Mr. Sidgmore and others worked during this period on a complicated transaction involving CompuServe Corporation ("CompuServe"), AOL and ANS Communications, Inc. ("ANS") (the "AOL Transaction").[16] WorldCom Management and the Board, moreover, appear to have analyzed this transaction in a reasonable manner and to have informed themselves adequately about it.

On September 4, 1997, WorldCom's Board met for a telephonic special Board meeting to consider and vote on the AOL Transaction. The AOL Transaction had the following

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15 Additional data about this transaction is contained in Appendix 1.

16 This AOL Transaction is to be distinguished from reciprocal agreements that WorldCom and AOL entered into in June 2001 under which WorldCom agreed to purchase advertising from AOL and AOL agreed to pay WorldCom more favorable rates for Internet-related services than it had in the past.

components: WorldCom acquired CompuServe from H&R Block for $1.3 billion; WorldCom transferred CompuServe's interactive services division and another CompuServe subsidiary to AOL, with WorldCom paying $175 million to AOL; AOL sold ANS to WorldCom for $500 million; and WorldCom entered into a five year outsourcing agreement to provide network capacity and services to AOL. Thus, the entire transaction, not including the outsourcing component, cost WorldCom $1.975 billion.

Management, led by Mr. Sidgmore and Mr. Cannada, did a significant amount of due diligence on this complex transaction. On September 2, 1997, Management sent each Director a Board package that contained a reasonably detailed description of the AOL Transaction and the rationale behind it. The Board then met telephonically on September 4th, and Management (chiefly Mr. Sidgmore and Mr. Cannada) reviewed the information distributed to the Board in the Board package and answered the Board's questions. The Board then approved the AOL Transaction, which closed in January 1998.

WorldCom did not engage a financial adviser on the AOL Transaction. This is somewhat surprising, given the significant dollar amount involved and the deal's complexity. No Board member is reported to have questioned Management's decision not to retain a financial adviser.

The AOL Transaction, however, seems to have made good strategic sense. In acquiring ANS, for example, WorldCom acquired assets similar to those that it had acquired with UUNET, and the acquisition thus enhanced WorldCom's Internet capabilities. Further, the five-year outsourcing agreement with AOL brought to WorldCom a billion-dollar-a-year customer.

Although Management did not retain a financial adviser in connection with the AOL Transaction, the Examiner believes that this transaction provides another example of Management properly doing its job, in part through giving the Board data sufficient to permit the

Board to inform itself about relevant facts and circumstances. The time between the September 2nd notice and the September 4th Board meeting was short, to be sure. Time was of the essence after some very intense negotiations, however, and although Management requested that the Board make a quick decision, it also provided the Board with sufficient information before and at the September 4th meeting on which to base that decision. Management's failure to use a financial adviser is somewhat problematic, but Management performed due diligence on this transaction over so long a period (more than eight months) that the WorldCom team probably became very familiar with its intricacies.

d. Brooks Fiber

WorldCom's acquisition of Brooks Fiber exemplifies the opportunistic nature of the Company's strategic planning from January 1997 through September 1998. Brooks Fiber was a competitive local exchange carrier ("CLEC") in secondary markets not previously served by WorldCom. WorldCom had acquired CLEC assets in major markets for the first time in the 1996 MFS transaction. The possibility of acquiring Brooks Fiber appears to have come to WorldCom's attention by chance, some time in July 1997. WorldCom moved rapidly and approved this $2.4 billion acquisition on September 29, 1997. There is no evidence that WorldCom's acquisition of Brooks Fiber was part of any long-term strategy to become a leading player in the CLEC market. However, its strategic rationale seems to have been to add non-overlapping CLEC assets to those previously acquired, thus enhancing the existing WorldCom CLEC network. It was described as a "like kind deal."

The WorldCom Board first learned of this potential transaction on September 11, 1997, during an executive session held after the regular Board meeting. Management told the Board that extensive due diligence had been performed and that more was yet to be completed. It does not appear that Management provided any documents concerning Brooks Fiber to the Board at that time, and notes of the Board's discussion of this possible transaction run for only eight lines, suggesting that Management provided the Board with only a very brief "heads up." Board members appear to have asked no questions on September 11, 1997 about the possible transaction.

On September 25, 1997, Management provided the Directors with a single-page memorandum informing them of a special Board meeting on September 29, 1997. This notice was not accompanied by any agenda or documents. The Board then met on September 29th to consider the Brooks Fiber transaction, as well as the MCI transaction discussed below. It appears that the Brooks Fiber discussion, led by Mr. Cannada, was brief (probably no more than 30-35 minutes) and that the Board was provided only with the proposed merger agreement.

The Examiner has identified a document, entitled "Project Black September 29, 1997," which appears to have been prepared by the WorldCom Corporate Development Department. The document is 13 pages in length and explains in considerable detail the reasons for the proposed Brooks Fiber transaction. This is the sort of document that the Examiner would have expected Management to provide to the Board prior to the September 29th Board meeting. The Examiner has preliminarily concluded that the Project Black document was used by Mr. Cannada as the basis for his Board presentation but that it was never actually provided to the Board. The Board minutes for the September 29th meeting specifically note that the Brooks Fiber merger agreement was provided to the Board. It appears to the Examiner that if the Project Black document had been provided, it would have been referenced as well.[17] Since the Project Black document appears not to have been provided to the Board in advance of the meeting, the

[17] The minutes for the September 29, 1997 Board meeting further reference various MCI-related documents provided to the Board at that meeting, reinforcing the view that the Project Black document probably was not provided to the Board.

Examiner finds it difficult to understand how the Board could have become fully informed about the transaction in merely a 30-35 minute oral presentation. [18] At a minimum, the Examiner observes that it was not a good practice to prepare a detailed explanatory document and then fail to give it to the Board.

WorldCom did not use a financial adviser on the Brooks Fiber transaction, although it had a $2.4 billion value. WorldCom's rationale in not retaining a financial adviser appears to have been that Brooks Fiber was a CLEC company and that WorldCom was already in the CLEC business and thus felt comfortable in performing its own valuation.

The Examiner has no basis at this time to conclude that Brooks Fiber was a misguided transaction that would have been rejected if the Board had taken more time to consider it. To the contrary, it appears that Management had carefully assessed the transaction and believed, with a reasonable written rationale, that it was in WorldCom's best interests. However, this might have been the first instance in which the Board approved a transaction without requiring Management to provide persuasive written data to justify the transaction. It would not be the last.

e. MCI[19]

WorldCom's merger with MCI further exemplifies the opportunistic nature of WorldCom's strategic planning during the January 1997 through September 1998 period. In late August or early September 1997, Mr. Sullivan appears to have conceived of the possibility of a

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[18] A former member of Management acknowledged that 30-35 minutes was probably too short a time, without provision of prior documentation, for the Board to have become fully informed about the Brooks Fiber transaction. He sought to justify the brevity of the discussion, however, by the fact that the much larger and more complicated MCI transaction was to be considered at the same meeting and that Brooks Fiber was just a "gnat" in comparison. The Examiner cannot agree. The Brooks Fiber transaction was, in and of itself, a significant transaction and the Board had an obligation not to move forward on it absent becoming fully informed. The Examiner has substantial doubt as to whether the Board in this instance fulfilled its responsibilities.

[19] Additional data about the MCI transaction is contained in Appendix 2.

mega-transaction in which WorldCom would acquire MCI. Although the size of this transaction was calculated to give WorldCom new credibility in the telecommunications market, WorldCom's merger with MCI was not the fruit of a long-term Company strategy to obtain the operations or assets of the type held by MCI. Rather, the opportunity to acquire MCI suddenly emerged when British Telecom ("BT") renegotiated its prior MCI merger agreement and WorldCom Management then immediately pursued the opportunity.[20]

It appears that WorldCom's Management and Board adequately informed themselves about the MCI merger before approving and proceeding with the transaction. At WorldCom's September 11, 1997 Board meeting, in executive session, Management first advised the Board that a hostile takeover bid for MCI might be possible and told the Board that Mr. Sullivan had already spoken with Salomon and outside lawyers about such a possibility.

The Board then initially considered and approved WorldCom's hostile takeover bid for MCI at a special Board meeting held on September 29, 1997. At the September 29th Board meeting, and again at a Board meeting held on November 9, 1997, at which the Board considered a revised MCI offer, Management and WorldCom's investment advisers and outside counsel made extensive presentations to the Board and provided the Board with many supporting documents.[21] The Directors were also reminded of their fiduciary duties in connection with the transaction. A special Board subcommittee on the MCI transaction was established and met on several occasions to consider details of the transaction.

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[20] It appears that a Salomon investment banker advised Mr. Sullivan that the BT/MCI renegotiation presented WorldCom with an opportunity, which Mr. Sullivan then pursued.

[21] Written data about the potential MCI transaction were not provided to the Board prior to September 29th because this was a hostile acquisition, and thus confidentiality was essential.

Thus, instead of being the product of a careful strategic process, the MCI merger a sudden opportunity for a $40 billion merger that could not be passed up. One Director commented that Mr. Ebbers' ego would not let such a deal go by and, accordingly, WorldCom's "strategy," as such, adjusted to the circumstances. This is not to state that the addition of MCI's extensive international network was not strategically important. It appears that WorldCom Management, after the MFS acquisition, had targeted international telecommunications as a growth area, and MCI brought significant international assets to WorldCom. The addition of MCI's large consumer business, however, had not been part of any WorldCom strategy. Further, as discussed in Chapter IV.C.5, below, the success of the MCI merger was impaired by Management's inability to integrate MCI and WorldCom successfully, a factor that Management and the Board may not have extensively considered prior to the closing of the merger. Therefore, the Examiner has preliminarily concluded that Management and its advisers appear to have conducted thorough due diligence and to have apprised the Board in detail about this transaction.

f. Conclusions

The Examiner has reviewed Board meeting minutes and other data from the period September 11, 1997 through September 14, 1998 to seek to identify any Board sessions devoted to strategic planning. No such planning is apparent, and, in interviews with personnel from WorldCom's Corporate Development Department and with Board members, we have not identified any significant attention to strategic planning. This may not be surprising, however, at a time when Management was devoting a great deal of effort to obtaining regulatory approval of the MCI transaction. At this time, the Examiner does not conclude that Management's and the Board's inattention to strategic planning reflects any error in judgment. The telecommunications industry and WorldCom in particular appeared to be achieving excellent results during this period and the opportunistic approach to expansion that Management and the Board followed appeared to be serving WorldCom well. Based on our current analysis of transactions that WorldCom entered into between January 1997 and September 1998, the Examiner further concludes that, with the exception of the Brooks Fiber transaction, Management provided adequate information to the Board, and that the Board appears to have informed itself adequately, about WorldCom's acquisitions.

3. Strategic Planning and Acquisition Processes in the Wake of MCI: October 1998 Through Early 2000

From September 1998 until early 2000, WorldCom's Management and Board appear to have engaged in more strategic planning than previously. Although Management's and the Board's strategic planning processes may not have been ideal, they were more deliberate during this period. However, the disturbing trend of Management providing scant data to the Board regarding proposed acquisitions continued and, in fact, appears to have accelerated during this period, with no apparent reaction or inquiry from the WorldCom Board.

a. Initial Strategic Planning

At the November 19, 1998 WorldCom Board meeting (the first after the September 14, 1998 closing of the MCI transaction), Management presented a "Strategic Planning and Development Report" as a scheduled part of the meeting. Although this report on strategic objectives could be faulted for its failure to include advance written information for the Board to consider, Management did lay out for the Board three strategic objectives for WorldCom to pursue over the next one to two years: (1) rationalizing some of MCI's assets (in particular, its MCI SystemHouse Corp. ("SHL") subsidiary), an objective that included entering into outsourcing arrangements, possibly with EDS; (2) pursuing broadband opportunities; and (3) expanding into wireless lines of business.

Such sessions devoted to strategic discussions appear to have continued at later Board meetings. The March 3-4, 1999 Board meeting, for example, included an executive session discussion about the pursuit of potential acquisitions in the wireless area (of which Nextel and SkyTel became examples), consistent with the November 1998 objective that WorldCom should consider expanding into wireless services and infrastructure. Further, in later meetings in 1999, the Board, consistent with the strategic report provided in November 1998, considered the acquisitions of SkyTel and Sprint, both of which had wireless assets.

The extent to which WorldCom's Management and Board fulfilled their fiduciary duties to the Company's shareholders to become adequately informed regarding significant transactions may be assessed in the context of the following specific acquisitions.

b. EDS[22]

The processes followed by Management and the Board in considering and approving the EDS transaction are troubling. Management failed to provide the Board with any written materials on this complex transaction, and the Board considered it for only 20 minutes prior to giving Management permission to proceed.

As noted in the discussion regarding strategic planning, Mr. Sidgmore advised the Board at the November 19, 1998 Board meeting of the possibility that WorldCom would sell SHL and seek to enter into outsourcing agreements with other entities, possibly including EDS. During late 1998 and early 1999, WorldCom and EDS personnel negotiated a series of tentative agreements that rivaled those of the AOL Transaction in their complexity. The contemplated agreements (collectively, the "EDS Transaction") were as follows: an agreement to sell SHL to EDS for $1.65 billion; a 10-year agreement under which WorldCom would outsource major

[22] Additional data about the EDS transaction is contained in Appendix 3.

portions of its information technology services to EDS at an estimated cost of $5-7 billion; a 10-year outsourcing agreement under which EDS would outsource its voice and data services to WorldCom under an agreement with an estimated value of $6.5 to $8 billion; and a joint marketing agreement.

On February 10, 1999, WorldCom Management convened a telephonic "informational" meeting of the Board to discuss the proposed EDS Transaction. It is unclear how much notice Board members received of this meeting. Of the 16 WorldCom Board members, three were unable to participate, and two joined the telephonic meeting late. The total duration of the telephone meeting was 20 minutes.

During the meeting, Mr. Sidgmore reviewed the proposed transactions, working from a draft memorandum that he had prepared for, but had not sent to, the Board. The participating Board members received no documents concerning the transaction in advance of the meeting. The Board did not vote on the EDS Transaction during this call. Notes taken by Bruce Borghardt, General Counsel for WorldCom's Corporate Development Department, regarding this informational Board meeting, however, reflect that a number of Directors favored the EDS Transaction.[23]

At the conclusion of the meeting, an unidentified member of WorldCom's Management is reported to have stated that Management appreciated the Board's participation and that Management "will proceed." WorldCom Management announced the EDS Transaction the next

[23] Mr. Borghardt acted as secretary to the WorldCom Board at many Board meetings, especially from November 1998 onward. Mr. Borghardt took copious notes, which have been made available to the Examiner and which have been a significant source of data about what occurred at various Board meetings. References to Mr. Borghardt's notes should not be construed as a waiver of any applicable privilege by the Company.

day, February 11, 1999.[24] It was not until three weeks later, at the March 3-4, 1999 Board meeting, that the Board officially approved the EDS Transaction. It does not appear that Management provided the Board with any new information on the EDS Transaction, or that the Board engaged in any material discussion regarding the EDS Transaction, prior to such approval on March 3, 1999.

The Examiner has serious corporate governance concerns about the EDS Transaction. First, both Mr. Sidgmore and outside counsel on the EDS transaction had prepared detailed memoranda addressed to the WorldCom Board explaining the EDS Transaction and its rationale. Neither memorandum was provided to the Board. Second, the EDS Transaction appears to have been complex and it involved billions of dollars. Given that fact, it is surprising that Management did not retain an investment adviser. One Director commented that it would have been wise to have an adviser, but that he thought Mr. Ebbers was trying to save money. Third, the Examiner doubts that the Board could have been adequately informed about this highly complex, multi-billion dollar transaction in a 20-minute informational call, particularly given that Management did not provide the Board with any documents in advance. Indeed, it appears that the WorldCom Board never received a single document from Management providing details of, or a rationale for, the transaction. Finally, the Examiner cannot discern any need for Management to have obtained Board approval on February 10, 1999. From a corporate governance standpoint, it would have been preferable for Management to wait for a sufficient time so that it could follow more orderly procedures.

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[24] While WorldCom February 11, 1999 Press Release did not specifically state that the WorldCom Board had approved the EDS Transaction, it clearly suggested that all necessary corporate approvals had been obtained.

The Examiner is not suggesting that the EDS Transaction did not make business sense as of early 1999. To the contrary, the Examiner is satisfied that WorldCom Management reasonably determined that the various components of the EDS Transaction, including the outsourcing, made sense.[25] The Examiner is troubled, however, by Management's disregard for the need to inform the Board fully of the details of the EDS Transaction, and the Board's apparent willingness to approve, without adequate data or opportunity for reflection, whatever Management proposed. The Examiner also is troubled by the fact that counsel does not appear to have provided any advice to Management or the Board about its fiduciary duties and the process that the Board should follow to ensure that it fulfilled all of its fiduciary duties.

c. Nextel[26]

As noted in our discussion of strategic planning, WorldCom Management advised the Board in November 1998 that it sought as one of its strategic objectives to make WorldCom an important player in the wireless communications sector within the next year or two. To that end, Management, in particular Mr. Sidgmore, began shortly thereafter to investigate the possibility of pursuing a takeover of Nextel Communications, Inc. ("Nextel"). The potential Nextel acquisition was first discussed with the Directors in an executive session of the Board following the March 3-4, 1999 Board meeting. Since this discussion occurred prior to the time that WorldCom and Nextel executed a nondisclosure agreement, it was based only upon publicly available data.

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25 The Examiner is aware that substantial disputes subsequently arose between WorldCom and EDS regarding EDS's failure to fulfill certain outsourcing obligations, and that some accounting irregularities may have arisen from the EDS Transaction as well.

26 Additional data regarding the possible Nextel transaction is contained in Appendix 4.

Mr. Sidgmore made a presentation in favor of pursuing the Nextel acquisition, stressing his belief that WorldCom needed a significant presence in the wireless field. Two Directors appeared to support him. At the same executive session, Mr. Sullivan expressed his serious reservations about the transaction, due in part to the significant debt that WorldCom would need to assume in a Nextel takeover. At least one Director appears to have agreed with Mr. Sullivan. The remaining members of the Board, including Mr. Ebbers, appear to have taken no “sides" on March 4, 1999, and the Board authorized Management to continue to investigate a potential deal.

Following the March 3rd and 4th Board meeting, WorldCom and Nextel executed a nondisclosure agreement, and WorldCom thereafter carried out extensive due diligence. WorldCom engaged Salomon Smith Barney ("SSB") and outside counsel to provide advice and assist in due diligence. SSB prepared a draft fairness opinion, and WorldCom and Nextel engaged in detailed negotiations to finalize a transaction.

Mr. Sidgmore recalled that the parties got to the point where they had agreed on all material terms, and that he had a “handshake” deal with Nextel’s largest shareholder. WorldCom and Nextel reached this agreement on or about May 6, 1999, and Mr. Sidgmore recalled that Mr. Ebbers had advised him that he had decided to support the acquisition. Later on the same day, however, Mr. Ebbers telephoned Mr. Sidgmore and told him that he had changed his mind and that the deal was off. On May 6, 1999, WorldCom publicly announced its decision not to pursue the Nextel transaction. It appears that Mr. Sullivan persuaded Mr. Ebbers to kill the transaction, possibly even threatening to resign if WorldCom proceeded to acquire Nextel.

The next meeting of the WorldCom Board was held on May 20, 1999. The Examiner has not found any evidence that the Nextel deal was discussed at that meeting.[27] The proposed

[27] One Director was quite adamant that outside Directors made the decision not to pursue Nextel. We have been unable to corroborate this recollection.

Nextel transaction would have been large, as its anticipated cost was in the range of $20 billion. It also represented a significant corporate opportunity, as it would instantly have made WorldCom a large player in the wireless field.

The Examiner concludes that there were significant pros and cons regarding a potential Nextel transaction, including the quantity of debt to be assumed and the nature of Nextel's wireless technology. Accordingly, the Examiner has not found any basis on which to question the process by which the Company ultimately decided to cease pursuing the Nextel acquisition in May 1999. It would be troubling to the Examiner, however, if Mr. Ebbers terminated the Nextel acquisition without providing the Board with an opportunity to participate in the final decision. As noted, WorldCom invested significant efforts in its due diligence on Nextel, and Nextel represented a significant corporate opportunity. The Examiner believes that, under such circumstances, Management should have brought the proposed transaction and the opposing views to the Board for detailed consideration, after the best possible transaction had been negotiated, and that the Board – not just one or a few members of Management – should have made the final decision whether to pursue the transaction.

d. SkyTel[28]

On May 28, 1999, WorldCom announced that it had reached an agreement to merge with SkyTel, a Jackson, Mississippi-based company in the wireless messaging business. The value of the transaction was about $2 billion. The Examiner has concerns about the extent to which the WorldCom Board became fully informed about this transaction, including its strategic rationale.

The possibility of a SkyTel transaction was first mentioned to the WorldCom Board at the March 3-4, 1999 Board meeting, during the executive session. The mention of SkyTel was

[28] Additional data about the SkyTel transaction is contained in Appendix 5.

apparently quite brief, with Management suggesting that a SkyTel transaction might make strategic sense in the context of a broader WorldCom entry into the wireless business, which would include the acquisition of Nextel.

Before and after March 4, 1999, a significant amount of SkyTel due diligence was undertaken by WorldCom's Corporate Development Department.[29] Then, on April 15, 1999, WorldCom put the SkyTel transaction on hold, apparently because it wanted to determine whether the Nextel transaction would proceed. WorldCom had preliminarily determined that an acquisition of SkyTel would make strategic sense only if the Nextel transaction went forward. As noted previously, on or about May 6, 1999, WorldCom terminated consideration of the Nextel deal. Notwithstanding that decision, WorldCom then informed SkyTel on that day that it might still be interested in acquiring SkyTel.

On May 20, 1999, the WorldCom Board held a regular quarterly meeting, followed by an executive session. The Board package for that meeting contained nothing about SkyTel, although the Corporate Development Department had compiled a great deal of information on SkyTel by that time. This is troubling, because it evidences Management's continued pattern of failing to provide the Board, in advance of Board meetings, with sufficient data concerning transactions to enable the Board to consider them thoroughly.

With regard to the May 20 executive session, Mr. Cannada made a presentation regarding the SkyTel transaction that appears to have lasted about 15 minutes and the discussion was described by one Director as "minimal." It does not appear that any documents were provided or presented to the Board on May 20, 1999. The failure of Management to provide documents to

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[29] WorldCom used no investment banker for, and obtained no fairness opinion on, the SkyTel transaction. It was viewed as a relatively small and straightforward transaction, and a number of Directors and one member of the Corporate Development Department were quite familiar with the paging business. One Director, however, assumed that a fairness opinion had been obtained.

the Board is troubling, because the Examiner has determined that, as was the case with the Brooks Fiber and EDS transactions, the Corporate Development Department had developed a document that could have been provided to the Board. This document, developed by no later than May 19th, described SkyTel and briefly discussed some of the potential benefits and risks of the transaction. It is possible that this document was used by Mr. Cannada during his oral presentation to the Directors, but it appears that it was never given to the Board.

The information compiled by the Examiner suggests not only that the executive session presentation was brief, but also incomplete. The presentation did not include certain data from Corporate Development, including the Corporate Development Department's conclusion that a SkyTel acquisition would not be strategic unless combined with other wireless acquisitions or that SkyTel had had "[l]ackluster results" in the last quarter of 1998 and the first quarter of 1999. Further, there is no evidence that Mr. Cannada or others in Management communicated their belief that this was a "mediocre" transaction, which, in fact, was their view. Directors do not recall hearing any such comment.

The Examiner is troubled over the extreme passivity of the Board in its consideration of the SkyTel transaction. The Examiner is not prepared to conclude that a properly informed Board would have rejected this transaction. It appears, however, that if all relevant data had been provided to the Board, it would have been, as of May 1999, a close decision whether this transaction was in WorldCom's best interests.

The Examiner further is troubled by the fact that a number of persons whom we interviewed appeared to consider the SkyTel transaction not to be substantial enough to merit much Board consideration. The Examiner disagrees. The transaction involved a total cost of about $2 billion, including assumption of long term debt that appears to have been in excess of

$315 million. Acquiring such a company, with recent losses, should have been undertaken only after careful deliberation and thoughtful consideration. The apparent attitude of WorldCom's Board, and possibly its Management, that such a transaction was too small to worry about is not acceptable, even in light of the Company's circumstances in 1999.

e. Sprint

The Examiner is generally satisfied with the procedures that Management and the Board followed in pursuing and acting upon the "mega" Sprint transaction, although the transaction ultimately failed due to opposition by European regulators and the United States Department of Justice. From June through August 1999, WorldCom Management conducted extensive due diligence and had preliminary discussions with Sprint. Then, on September 9, 1999, Management provided the Board in executive session with a "heads up" about the potential transaction. Management also distributed to the Board materials from SSB in advance of an October 4, 1999, special Board meeting and distributed additional materials at the meeting. The minutes of the Board meeting and the Acting Secretary's notes from this meeting reflect extensive consideration of the proposed merger, as well as advice from counsel regarding the Board's fiduciary duties. WorldCom's attempt to merge with Sprint clearly fit with the Company's strategic goal of becoming a player in the wireless area, although it is not clear how Sprint's remaining assets fit within WorldCom's strategy.

4. Strategic Planning and Acquisition Processes from Early 2000 Onward

The Examiner has even more concerns about the Board's and Management's attention to acquisition strategy in the context of a coherent strategic plan from early 2000 onward. By early 2000, WorldCom's stock price had been falling for six months and the Company's revenue growth had been modest since completion of the MCI transaction. As a consequence, the

Examiner believes that, by early 2000, and certainly by the time the Sprint merger was abandoned in July 2000, Management and the Board were obligated to examine seriously WorldCom's future direction. Based upon available information, however, the Examiner believes that the Board and Management engaged in strategic planning practices at this time that were seriously deficient.

As of early 2000, it was apparent that there were significant differences among WorldCom Management as to the strategic direction that the Company should take. During the executive session of the March 2, 2000 Board meeting, Mr. Sidgmore gave a lengthy presentation in which he made clear that he disagreed with the strategic direction that the Company was taking and that he thought that WorldCom should effect a transition from being a telephone company to being a high-technology data company. He voiced his views and responded to Board reactions for over an hour. Such a presentation might be viewed as positive and strategic, except for Mr. Ebbers' introduction: "These are John's views, management has not agreed to [them]." Indeed, Mr. Ebbers disagreed with most of Mr. Sidgmore's views as of March 2000. There is no indication in the Acting Secretary's notes from this executive session or from our interviews that Management or the Board made any decision as to the strategic direction that the Company should take at this time.

The lack of coherent strategic planning in early 2000 may be explained, at least in part, by the fact that the Sprint merger was then pending and members of the Board and Management appear to have believed, at least until approximately June 2000, that WorldCom's proposed merger with Sprint would eventually surmount regulatory hurdles. After these regulatory obstacles caused WorldCom and Sprint to abandon the merger in mid-July 2000, however, Management and the Board apparently recognized that these obstacles would preclude any large acquisitions in the future and that the Company would have to pursue a different strategic direction in order to grow. At this point, the need for careful strategic planning should have been clear.

The Examiner preliminarily concludes that WorldCom's strategic planning efforts and its acquisition activities in 2000 and 2001 reflect significant problems, which probably caused substantial damage to WorldCom. We cover three particular matters in detail: WorldCom's entry into the managed Web hosting business and the related Intermedia acquisition; the creation of the Tracker stocks; and the failure to pursue WorldCom's potential acquisition by Verizon. These matters point to the continued passivity of the WorldCom Board, even in the light of manifest disregard by Management for proper corporate governance procedures. In short, at a time when the Board should have been more assertive, it instead became increasingly passive and submissive.

a. Managed Web Hosting Business/Jaguar

As discussed above, there was internal debate among WorldCom Management about the Company's direction in early 2000. At the executive session of the March 2, 2000 Board meeting, Mr. Sidgmore provided to the Board his view of needed changes in WorldCom's strategic direction. As part of Mr. Sidgmore's March 2, 2000 presentation, he suggested that WorldCom should become a player in the managed Web hosting business. WorldCom had been involved in Internet-related businesses since at least late 1996, when it acquired UUNET. UUNET's Internet business, however, was focused on providing network backbone. In contrast, the managed Web hosting business was more sophisticated and involved sales of extensive Web-related applications and services to business customers and the capacity to manage all of a business customer's Internet-related activities. On March 2, 2000, Mr. Sidgmore informed the

Board that he believed that WorldCom should enter the managed Web hosting business through a joint venture with Andersen Consulting (code named "Jaguar").

At the Board meeting held on June 1, 2000, Management informed the Board again that it was investigating a joint venture between WorldCom and Andersen Consulting. This joint venture would have provided WorldCom with a virtually cost-free means of entering the managed Web hosting business through a combination of portions of WorldCom's Internet assets with Andersen Consulting services. After discussion, the Board voted on June 1, 2000 to authorize Management to proceed with Jaguar, provided that Management could negotiate satisfactory terms for the transaction. Thereafter, Mr. Sidgmore and others continued to pursue the Jaguar joint venture, and by late August, a transaction was nearly negotiated.

Mr. Ebbers was supportive of WorldCom's entry into the managed Web hosting business. Over time, however, it appears that Mr. Ebbers came to believe that WorldCom should pursue this objective through an acquisition in the managed Web hosting field, instead of the joint venture. To that end, the WorldCom Corporate Development Department began in July and August 2000 to investigate potential acquisition targets, including both Intermedia and Digex. The Corporate Development Department reviewed confidential information packages prepared by Bear Stearns, financial advisers to Intermedia and Digex, about both entities and performed analyses as well. Although WorldCom Management had an interest in acquiring Digex, Mr. Ebbers decided in early August 2000 to pursue the possibility of a combination with Global Center, another managed Web hosting entity.

Instead of acquiring Global Center or entering into the Jaguar joint ventures, WorldCom, on September 1, 2000, suddenly abandoned the strategy of entering the managed Web hosting business via a low cost joint venture and decided to pursue a $6 billion acquisition of Intermedia, in order to gain control of Digex, which was controlled by Intermedia. The Board had never previously discussed the acquisition of businesses like Intermedia and Digex. Nevertheless, it swiftly changed its "strategic direction" from the pursuit of the Jaguar joint venture to a transaction that ultimately proved highly inadvisable.

b. Intermedia[30]

On September 5, 2000, WorldCom and Intermedia announced that they had entered into a merger agreement, approved on September 1, 2000, by each of their Boards. At that time, Intermedia was engaged primarily in the competitive local exchange carrier business ("CLEC"), but also owned a controlling interest in Digex. WorldCom's primary interest in acquiring Intermedia was to enter the managed Web hosting business through control of Digex. As of September 5, 2000, the transaction was estimated to cost about $6 billion ($3 billion in equity and $3 billion in debt assumption).

The Examiner preliminarily concludes that WorldCom's Board and Management failed to satisfy their fiduciary duties to become fully informed about the Intermedia/Digex transaction, both at the outset on September 1, 2000, and subsequently in early 2001, when WorldCom agreed to amend its merger agreement with Intermedia. The Examiner further concludes preliminarily that if the Board and Management had complied with their fiduciary obligations, this transaction might not have been approved on September 1, 2000, and it almost certainly would have been abandoned in early 2001. Finally, the Examiner preliminarily concludes that by continuing with the transaction, WorldCom wasted Company assets amounting to at least several billion dollars. The exact amount is subject to future calculation.

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30 Additional data pertaining to the Intermedia transaction is contained in Appendix 6.

i. WorldCom's Interest in Digex

In August 2000, WorldCom was investigating a possible combination with Global Center. Global Center personnel were scheduled to visit WorldCom's headquarters in Jackson, Mississippi, on Thursday, August 31, 2000. On August 30th, Global Center informed WorldCom that it understood that the meeting was a week later. This caused Mr. Ebbers to become suspicious and, after several phone calls, Management discovered that Global Center was pursuing the acquisition of Digex. Mr. Ebbers is reported to have been greatly upset with what he viewed as questionable conduct by Global Center, and Mr. Ebbers that day decided that WorldCom would seek to acquire Digex.

At approximately 1:30 p.m. on Thursday, August 31st, a team from WorldCom arrived in New York at the offices of Intermedia's attorneys. They met first with Intermedia lawyers and principals and later with Digex principals. At this time, WorldCom's intent was to pursue an acquisition of Digex, which was expected to cost in the range of $8 billion. Later in the afternoon, the focus changed to an acquisition of Intermedia, at a lesser price, which would also give WorldCom control of Digex. By evening, WorldCom had made a $6 billion offer for Intermedia. It appears that WorldCom's due diligence was minimal. One member of Management, who was part of the WorldCom team in New York, estimated that actual due diligence meetings on August 31 lasted between 60 and 90 minutes.

Intermedia informed WorldCom that a deal had to be concluded by 5:00 p.m. on Friday, September 1, 2000, or Intermedia and/or Digex would likely complete a deal with some other entity. Late in the afternoon of August 31st, WorldCom engaged Chase Securities as its financial adviser on the transaction.[31]

[31] SSB had been advising WorldCom on Intermedia and Digex, but resigned on the afternoon of August 31, 2000 due to a conflict of interest.

As noted, WorldCom's only interest in seeking to acquire Intermedia was to gain control of Digex. WorldCom was not interested in its CLEC assets and instead planned to sell these non-Digex assets in order to reduce the overall cost of the transaction. WorldCom was concerned, however, about Section 203 of the Delaware Corporate Law, which would have prohibited a combination of Digex and WorldCom for three years. WorldCom was eager to have the flexibility to combine WorldCom and Digex sooner than that and thus insisted on obtaining a Section 203 waiver.

Late in the morning of September 1st, Chase Securities sent Mr. Sullivan certain valuation analyses of Intermedia and Digex, which Chase apparently had prepared during the preceding 18 hours. The Chase data did not contain a specific estimated value of Intermedia's non-Digex assets, although one graph suggested a value of between \$3.1 and \$3.5 billion. On September 1, 2000, Mr. Sullivan also received much lower estimate of \$1.457 billion from the WorldCom Corporate Development Department

ii. The September 1, 2000 WorldCom Board Meeting

WorldCom Management convened a telephonic Board meeting at 3:30 p.m. Eastern time on September 1, 2000. It is unclear how much notice Management gave the Board of this meeting. One Director recalled getting 90 minutes notice and participating in the meeting by cell phone. Besides the Directors, the meeting was attended by the WorldCom team that was in New York, by Messrs. Ebbers and Sullivan who were in Mississippi, by WorldCom General Counsel Michael Salsbury, who served as Acting Secretary from Washington, D.C., and by representatives from Chase Securities and an outside law firm. The meeting lasted 35 minutes.

Mr. Ebbers described the background to the transaction, including the fact that the WorldCom team had not arrived in New York until the day before the meeting and that Chase Securities had not been engaged until late that day. He also explained that WorldCom had no real interest in Intermedia, a CLEC entity with a network that overlapped with the WorldCom network in eight of 14 cities. Mr. Ebbers advised the Board that WorldCom's intent would be to sell the non-Digex assets. Mr. Ebbers also explained that WorldCom would pay $39 per share for Intermedia common stock, which was currently trading at $22 per share. Mr. Ebbers emphasized that the acquisition of control of Digex would make WorldCom an important player in the managed Web hosting market much faster than the contemplated Jaguar joint venture.

Next, the WorldCom team briefly described its August 31st meetings with Intermedia and Digex personnel and presented their general views on the transaction. Mr. Sullivan then informed the Board that, if WorldCom proceeded with the transaction, it would issue approximately $3 billion in stock and assume $3 billion in debt. He also stated that WorldCom could likely sell Intermedia's non-Digex assets for close to $3 billion. The Chase Securities representative made a brief presentation about the estimated value of Intermedia, suggesting that Intermedia's non-Digex assets could be worth as much as $3-3.5 billion, but provided no fairness opinion, and no one asked about its absence or even questioned the basis for the estimate.

Mr. Ebbers stated that WorldCom, in effect, was in an auction, an apparent reference to the competing bid that Intermedia and/or Digex allegedly planned to accept if a WorldCom deal were not struck by 5:00 p.m. After brief further discussion, the Board approved the deal unanimously. No Director voiced any objection to the transaction.[32] No one advised the Board of its fiduciary responsibility to become informed about all relevant facts.[33]

This approval process troubles the Examiner. The Examiner understands that in mergers and acquisitions it is sometimes necessary to act with considerable speed. However, the speed of the $6 billion Intermedia transaction seems quite extraordinary - described as "warp speed" by one member of Management - and it is difficult to conceive how the WorldCom Board could have become adequately informed in the course of a 35-minute "presentation" and without having reviewed any supporting documentation. As one Director stated when asked whether the Board was adequately informed regarding the proposed acquisition of Intermedia on September 1, 2000, "God himself could not have made the decision in one day." Indeed, this appears to be an instance in which the Board simply proceeded based upon Management's word and nothing else.[34]

At the time of the September 1, 2000 Board meeting, WorldCom's financial performance, like that of other telecommunications companies, was declining, and the Board

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32 One Director, who had been very involved in the Jaguar joint venture effort, recalled hearing about the meeting from Mr. Ebbers at about 2:00 p.m. on September 1 and telling Mr. Ebbers that he did not think that a $6 billion Intermedia acquisition made sense when compared to the much less expensive Jaguar joint venture. This Director did not repeat these views at the September 1st Board meeting and voted for the transaction to make the vote unanimous. Other Directors had doubts as well but did not express them.

33 The Acting Secretary to the Board informed the Examiner that he took detailed notes of the Board meeting because he knew that they would likely be important to a Hart-Scott-Rodino filing. The notes reflect no person advising the Board of its fiduciary responsibilities. Others recollect no such advice.

34 Several persons whom we interviewed suggested that the Board might have been sufficiently informed about the Intermedia transaction because the Board had heard about managed Web hosting on two prior occasions – the March 2 and June 1, 2000 presentations by Mr. Sidgmore. The Examiner disagrees. Those discussions concerned managed Web hosting in general and the Jaguar joint venture specifically. There was never any discussion of a transaction such as the Intermedia acquisition, which cost approximately $6 billion and was premised in part on WorldCom's unsubstantiated ability to sell Intermedia's non-Digex assets for $3-3.5 billion.

should, as a consequence, have been exercising extra care in evaluating the Company's proposed acquisitions. Instead, it appears to the Examiner that the Board brought virtually no scrutiny to bear on this transaction. One Director stated that the Intermedia transaction was the worst ever completed by WorldCom. Another Director said that "Intermedia was the worst transaction we did" and that "[w]e paid $6 billion and got nothing in return." This same Director also stated that Mr. Sullivan at some point described the Intermedia acquisition as an "ego deal for Bernie," because Mr. Ebbers did not want Global Center to get Digex. Another Director commented that, with respect to the Intermedia transaction, the Board received "no information" and that the deal should not have been approved on September 1, 2000. He said that the Board had been pressured by Mr. Ebbers to approve the deal. Still another Director stated during an interview when the discussion turned to the Intermedia transaction, "pardon me while I throw up."

iii. The Amendment to the Merger Agreement

As troubling as the September 1, 2000 Intermedia approval process appears, the Examiner is even more troubled by subsequent events. The Intermedia transaction underwent significant changes, which gave WorldCom the right to abandon the acquisition. Instead, Management, with no prior Board approval, decided to renegotiate the transaction and to amend the merger agreement. When this ultimately came to the Board's attention, Board members did not object. The Examiner believes that this process reflects a severe failure on the part of both Management and the Board.

During the fall of 2000, several events occurred that affected the WorldCom/Intermedia merger in material respects. First, shortly after the announcement of the merger, Digex minority shareholders commenced litigation against Intermedia, WorldCom and others, claiming (among other things) that the Section 203 waiver was improper and that minority shareholders were getting insufficient value for their interests in Digex. This litigation was reported to the

WorldCom Board at its meetings on September 7 and November 16, 2000. On December 13, 2000, the Delaware Chancery Court issued a decision in which it refused to enjoin the merger, but suggested that WorldCom, if it went through with the merger, could be exposed to significant damages – reportedly as high as $2.5 billion. WorldCom's Directors were at least generally familiar with this decision.

Second, during the fall of 2000 and thereafter, the market for CLEC assets fell sharply, and efforts by Chase Securities to market the Intermedia assets were unsuccessful. Several persons at WorldCom who were involved in the Intermedia transaction stated that, if the decline in the value of CLEC assets could have been predicted, the Intermedia deal clearly would not have made sense from the outset. At a minimum, Management should have been aware that the sharp decline in CLEC values necessitated reconsideration of the Intermedia deal, because the Board previously had been advised that the Intermedia assets could bring $3-3.5 billion and pay down all the Intermedia debt. On November 16, 200, Management informed the Board that it had been unable to find a purchaser for Intermedia's assets, and Directors have confirmed that they were generally aware of the decline in the value of the Intermedia assets.

As a result of these developments, WorldCom took the position in early 2001 that it was free not to continue with the Intermedia merger. Indeed, Mr. Salsbury recalls a detailed conversation around Christmas 2000 with Mr. Ebbers in which he advised Mr. Ebbers that WorldCom could terminate the transaction. Outside counsel had similar conversations with Mr. Salsbury, Mr. Ebbers and Mr. Sullivan.

Nevertheless, WorldCom decided not to walk away from the deal. Instead, Management negotiated and executed, with no prior Board approval, the following agreements:

- A settlement of the Digex litigation, requiring WorldCom to pay $15 million and to issue $165 million of WorldCom stock to a settlement fund for Digex minority shareholders;
- An agreement with Digex requiring WorldCom to enter into a series of commercial arrangements, as well as an agreement after the completion of the Intermedia merger to fund Digex's business plans for 2001 and 2002, at a projected cost of as much as $900 million; and
- An amendment to the WorldCom/Intermedia merger agreement, reducing the exchange ratio to one share of WorldCom stock for each share of Intermedia stock and changing other terms so that it would be much more difficult for WorldCom to abandon the transaction if Intermedia's financial fortunes were to worsen further, as they subsequently did.

The cost to WorldCom of the overall transaction, not including the funding of Digex in 2001-02, and not including the $15 million in cash and $165 million in stock paid in the Digex settlement, was estimated in a related registration statement filed on Form S-4 to be $4.974 billion as of February 13, 2001.[35]

The merger amendment was executed on behalf of WorldCom by Mr. Salsbury on February 14 or 15, 2001. Mr. Salsbury advised the Examiner that he believed that Board approval had previously been obtained and that he was informed by Mr. Sullivan or Mr. Ebbers that he could sign the amendment on WorldCom's behalf. The Examiner's investigation has revealed that no prior Board approval had been obtained and to date, the Examiner has found no

[35] Separately, a member of WorldCom's Investor Relations Department estimated the cost of the merger as of February 15, 2001 as follows:

Value of WorldCom Equity to be issued	$1,257,510,000
Intermedia Debt to be assumed	2,462,000,000
Intermedia Preferred Stock to be acquired	656,000,000
Digex Settlement Fund	165,000,000
Digex Litigation Expenses	15,000,000
Estimated Intermedia Cash	(340,000,000)
	$4,215,510,000

evidence that Management had polled the Directors for their views before executing the amended agreement.[36]

The Examiner is continuing to investigate the circumstances under which WorldCom's Management executed a material amendment to the Intermedia merger agreement with no prior Board approval. At present, the facts appear to be as follows.

- During the first two weeks of February 2001, there were intensive negotiations to settle the Digex litigation, which negotiations apparently tied any such settlement to an amendment to the WorldCom/Intermedia merger agreement.
- At a meeting on February 7, 2001, WorldCom reached a tentative agreement with Intermedia as to certain revised terms of the merger agreement, subject to Board approval.
- On February 12, 2001, with most or all of the terms of the amended merger agreement apparently negotiated, outside corporate counsel to WorldCom sent an e-mail to Mr. Borghardt, inside counsel for WorldCom, attaching a proposed Written Consent by which the WorldCom Board would approve the merger agreement amendment, the Digex settlement, and the Digex commercial agreements. This e-mail and its attachment reflect the apparent understanding among legal counsel that WorldCom Board approval was required.
- On February 13, 2001, at 1:10 p.m., Mr. Borghardt sent Mr. Salsbury and outside counsel a revised draft of the Written Consent that incorporated Mr. Borghardt's suggested revisions. The cover e-mail stated that once Mr. Salsbury approved the draft, Mr. Borghardt would obtain Mr. Ebbers' approval and then "route it to other Directors." This communication appears to reflect counsels' understanding

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36 One former Director advised the Examiner that he could not recall being polled before the Intermedia merger amendment was executed but that he was confident that Mr. Ebbers had done so. The Examiner has two observations in response. First, there is no evidence that any such polling took place. We talked with many Directors and asked all or virtually all about possible polling. Not one had a specific recollection that it occurred and a number stated that they were sure it did not occur.

Second, while polling would alleviate some of the Examiner's concerns, polling would not eliminate the most significant concerns. The Intermedia merger amendment, with the Digex settlement as part of it, was a complex revision to the original transaction, which would be difficult to summarize adequately in a brief polling telephone call. Further, for polling to have been complete and adequate, Directors would have needed information regarding the status of the Intermedia asset sale efforts and how the lack of sales would likely affect the economics of the transaction. There is no evidence of any such disclosures. In sum, even if there had been polling, the Examiner preliminarily concludes that it is still likely that both Management and the Board failed to fulfill their fiduciary duties.

that no Board approval had been obtained as of the afternoon of February 13, 2001.

- According to a February 14, 2001 e-mail to Mr. Sullivan from his secretary, Mr. Salsbury was pressured by Intermedia's investment bankers to have WorldCom execute the merger amendment, which Mr. Salsbury reportedly had said must be signed on February 14.

- On February 14, 2001, Mr. Salsbury received from another in-house counsel a Chase update on efforts to sell Intermedia's assets, stating that the best, hoped-for bid for all of the assets was between $800 million and $1.8 billion – far less than the estimates given to the Directors on September 1, 2000. There is no evidence that the new estimate was presented to WorldCom's Board.[37]

- On February 14, 2001, or possibly February 15, 2001, Mr. Salsbury executed the first amendment to the merger agreement, apparently after being authorized to do so by Mr. Ebbers or Mr. Sullivan. Mr. Salsbury informed the Examiner that Mr. Ebbers told him that the Board already had approved the amended merger agreement.

- On February 15, 2001, WorldCom issued a press release announcing the Digex settlement and the amended merger agreement. The release stated falsely that WorldCom's Board had approved the Digex settlement. Similarly, a subsequent SEC filing by WorldCom on Form S-4 stated falsely that "[t]he WorldCom board of directors approved the merger as contemplated in the amended merger agreement on February 14, 2001."

- In fact, the WorldCom Board did not actually approve the Digex settlement and the amended merger agreement until it met on March 1, 2001.

On March 1, 2001, a written consent resolution was circulated at the quarterly Board meeting, where Mr. Salsbury briefly (10 minutes or less) described the terms of the Digex settlement. There is no indication that any Director at the meeting spoke up or questioned the actions of Management.[38] Rather, the Board was asked to and did rubber-stamp Management's

[37] Scott Hamilton, former head of the Investor Relations Department at WorldCom, informed the Examiner that he believed it was "common knowledge" by February 2001 that the Intermedia assets were worth less than $1.4 billion.

[38] One Director advised the Examiner that he spoke to Mr. Ebbers in private and expressed his view that proceeding with the Intermedia merger was a grave mistake. The same Director spoke in private with Mr. Sullivan, who agreed that the acquisition of Intermedia was inadvisable, but who told him that Mr. Ebbers was determined to acquire control of Digex. Another Director said the Board had the opportunity to call off the deal, but failed to do so. Certain Directors also suggested that they might not

actions, receiving no substantive data as to why the amended merger agreement made sense. There is no indication that any Director asked for or received an estimate of the value of the Intermedia assets as of March 1, 2001. Instead, it appears that Mr. Salsbury merely reported that sale efforts were continuing, but that he made no estimate of the possible proceeds from any eventual sale of Intermedia's assets. If the Intermedia assets were believed to be worth as little as $800 million as of mid-February 2001, then the estimated $4.974 billion price of the transaction suggested that the associated costs to WorldCom would be substantially higher than the Board assumed when it approved the initial deal.

As of September 1, 2000, the Intermedia merger was expected to cost about $6 billion, with $3 billion of WorldCom equity issued and $3 billion of debt assumed. The $6 billion cost was then to be reduced to $2.5-3 billion, through sale of the Intermedia assets for $3-3.5 billion. As of February 2001, the Intermedia transaction was expected to cost $4.974 billion, plus up to $900 million for Digex operating costs and $180 million of cash and stock for the Digex settlement, for a total cost of as much as $6.054 billion. The prospect of reducing that price by even $1 billion through the sale of Intermedia assets was remote. Accordingly, by February 15, 2001, the "price" of this transaction had risen greatly since September 1, 2000.

iv. Preliminary Intermedia Conclusions

Although the Examiner's investigation is continuing, we have sufficient information to set forth some preliminary conclusions related to the Intermedia transaction.

First, the WorldCom Board never received any documents relating to this transaction. The Examiner finds it disturbing, and almost certainly contrary to its fiduciary responsibilities,

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have been aware that Management had already executed the merger amendment. This does not seem credible. Board members have acknowledged reading The Wall Street Journal, which, on February 16, 2001, reported on the amended merger agreement.

for the WorldCom Board to have approved such a material transaction without demanding more information. The Board's conduct with respect to the Intermedia transaction is similar to the violative conduct of the Board in the Smith v. Van Gorkom case discussed previously.

Second, the Examiner's investigation has revealed that certain Directors had doubts about this transaction from the outset and great doubts as of March 1, 2001. They also had doubts about Mr. Ebbers' leadership after the Company's loans to him were revealed in November 2000.[39] The Examiner cannot discern why the outside Directors, at a minimum, would not, by March 1, 2001, have recognized their responsibility to consider carefully possible actions to take, including whether Mr. Ebbers should continue as WorldCom's Chief Executive Officer. This is particularly so because, at that March 1, 2001 Board meeting, a special executive session was convened without Mr. Ebbers, to enable the Board to discuss threatened litigation regarding the Company's loans to Mr. Ebbers. Given the fact that the Board was then aware that Management had committed WorldCom to the Intermedia deal without Board approval, the Examiner believes that the Board should have used the occasion to discuss Mr. Ebbers' leadership, as well as possibly the roles of others. Nevertheless, to the Examiner's knowledge, nothing of the sort occurred.

Third , the Examiner preliminarily concludes that if the WorldCom Board had fulfilled its fiduciary responsibilities, it likely would have rejected the Intermedia merger as of the February 2001 amended agreement. A properly informed Board would have learned that the prospects for any large proceeds from an Intermedia asset sale were slim. A properly informed Board also would have learned that Digex's operating results were not overly robust and that it might cost WorldCom as much as $900 million to fund Digex's business plan over the next two years.

[39] One Director informed the Examiner that, at least for this Director, confidence in Mr. Ebbers was "totally eroded" when the loans were revealed to the full Board.

Further, a properly informed Board would have learned that hoped-for synergies between Digex and WorldCom would be difficult to achieve. See Section C.5 of this Chapter, infra. At a minimum, the decision whether to approve the amended merger agreement, particularly at a time when WorldCom's results were quite disappointing, should have been a very difficult one for the Board, engendering considerable debate.

Fourth, we have noted numerous other instances – Brooks Fiber, EDS, SkyTel and Intermedia – which have raised serious questions whether the Board satisfied their fiduciary responsibilities to become informed before authorizing a transaction. In those instances, there is no indication that any attendee advised the Directors whether they had adequate information and time to approve a transaction. The Examiner's many interviews with former Directors underscore this lack of advice. A common response, however, has been that the WorldCom Board was quite familiar with its fiduciary responsibilities and thus, the lack of an express reminder was no matter of concern. The Examiner disagrees. The Examiner has carried out an extensive investigation, which is continuing, and preliminarily concludes that the WorldCom Board was not well versed in its fiduciary responsibilities. To the contrary, the Board repeatedly approved acquisitions and other actions (See, e.g., Ebbers loan discussion in Chapter VI, infra) with little or no information and almost no inquiry. A Board vigilant about fiduciary duties would not have been so passive.

The Examiner is continuing to investigate the damages and losses that WorldCom incurred as a result of the apparent failure of its Board and Management to fulfill fiduciary duties pertaining to the Intermedia transaction. The Examiner notes preliminarily that WorldCom has reported in its 2001 Form 10-K that the Intermedia acquisition ultimately cost approximately $5.8 billion and that the Company thus far has been able to realize only about $100 million from sales of Intermedia's assets – only a small fraction of the September 2000 estimates of $3 – $3.5 billion. The Examiner understands that the Intermedia assets that have not been sold are resulting in additional losses, adding to the potential damages from this transaction. Finally, Digex's results since July 1, 2001, also have been poor, although the Examiner has not quantified its performance.

c. The Tracker Stocks

On November 1, 2000, WorldCom announced the creation of the Tracker stocks that divided WorldCom into two groups for stock exchange listing purposes: the WorldCom Group, containing the high growth portions of the Company (data, Internet, Web hosting and international); and the MCI Group, containing the slower-growth, but higher cash flow, businesses (consumer, small business, wholesale long-distance, paging, voice and dial-up Internet access). This was a significant step for WorldCom, representing a strategic decision to attempt to address the continuing decline in WorldCom's stock price and a perceived failure of the market to reflect the real value of WorldCom's assets.

Any decision to create the Tracker stocks should have been made only after the most careful consideration, taking into account the detailed advice and recommendations of outside advisers with prior experience and expertise. That did not occur in this case . We set forth in Appendix 7 a chronology of Tracker stock decision-making, which we summarize here.

The WorldCom Board first considered the possibility of creating the Tracker stocks at its March 2, 2000 meeting. This discussion was brief and the Board made no decisions. No investment banking advisers were present, although WorldCom Management had separate meetings on Tracker issues with J.P. Morgan Securities, Inc. ("J.P. Morgan") and SSB at about this time.

Beginning no later than the summer of 2000, WorldCom's Management began communicating regularly with SSB and J.P. Morgan Securities regarding restructuring alternatives. On July 12, 2000, SSB sent Mr. Sullivan and Mr. Ebbers a document entitled "Spin-Off and Tracking Stock Considerations." The document contained a variety of restructuring ideas, including a spin off or sale of the consumer business and various Tracker stock scenarios, including one in which both a spin off and Tracker stocks were considered. There is no evidence that this SSB document, or any other document analyzing the various restructuring/Tracker alternatives, was ever provided to WorldCom's Board.

Subsequent to July 12, 2000, WorldCom's Management, led by Mr. Sullivan, continued to evaluate restructuring options. There were multiple meetings in August 2000 and Mr. Salsbury was asked to consider potential regulatory issues that might influence WorldCom's pursuit of various alternatives.

The Board next addressed creation of the Tracker stocks during the executive session following the September 7, 2000 Board meeting. This discussion was far more extensive and detailed than that which took place on March 2, 2000, with the Acting Secretary, Mr. Borghardt, taking 17 pages of notes. The Board discussed three restructuring options: selling the Company's consumer unit (the legacy MCI consumer unit); spinning off the consumer unit; and creating Tracker stocks for the high growth and high cash flow units. The Acting Secretary's notes reflect that discussion opened with Mr. Ebbers commenting that "all analysts talk about restructuring [but there is] no unanimity." The Board and Management engaged in a lengthy discussion of the options, with Management presenting a series of slides, but no other documentary data. No investment bankers were present. On several occasions, Directors referred to the potential Tracker stocks as "financial engineering," and one Director questioned whether the Tracker stocks would create value or were “just engineering.” Several members of the Board indicated a preference for a sale or spin-off of the MCI consumer-oriented business, but they were told by in-house counsel that each of those alternatives presented regulatory issues. When an outside Director later challenged the idea that regulatory issues would bar a spin-off or sale, in-house counsel confessed to not being an expert on spin-off regulatory issues.

The September 7, 2000 executive session adjourned after a lengthy discussion. No vote was taken. At the end of the meeting, Mr. Ebbers commented that "no one likes it, but [the] consensus is [we] have to do something and tracker is the best thing right now." Mr. Ebbers also stated that it was “not pretty but ugly out there now” and that we “have to get it done.” He also referred to “making rounds at investors' conferences.” Based upon these comments, it appears that Mr. Ebbers may have believed a consensus had been reached that the Tracker stocks would be pursued, and at least two Directors seem to recall that. However, it also is clear that no corporate authorization to pursue the Tracker stocks had been voted upon.

The Examiner acknowledges that a healthy discussion took place at the September 7, 2000 Board meeting. The Examiner is concerned, however, that Management may have pursued the Tracker stocks primarily because they could be implemented faster than other alternatives and because Management believed that the Tracker stocks would be favorably received at investor conferences - not because it necessarily was the best strategic alternative for the Company. No outside legal or financial advisers were present to help the Board become fully informed about potential benefits and risks associated with the Tracker stocks and the alternatives to the Tracker stocks. It is not clear how much expertise personnel within WorldCom had to evaluate the Tracker stock alternative or present the Board with reliable and balanced advice. WorldCom Management apparently had some knowledge of Tracker stock issues, because Sprint had a Tracker stock. In addition, Directors who came from MCI had some familiarity with these matters, because MCI (with the assistance of an investment banker) had considered and rejected the creation of MCI Tracker stocks.

Subsequent to September 7, 2000, Management continued to work with investment bankers on Tracker stock matters and outside counsel became involved as well. Then, in early October 2000, WorldCom Management decided (with no further Board meeting) that the Tracker stocks would be announced at an analyst conference scheduled for November 1, 2000. J.P. Morgan and SSB were formally engaged as advisers to address Tracker issues on October 11, 2000, and each would eventually be paid $3.5 million.

There is no evidence that the outside Directors of WorldCom were informed of Management's plan to implement the Tracker stocks until October 31, 2000. On October 31, 2000, at 5:00 p.m., WorldCom's Management convened an informational meeting of the Board by telephone conference.[40] The meeting commenced with Mr. Ebbers stating that the two Tracker stocks (WorldCom Group and MCI Group) would be announced the next day and that WorldCom would also announce new, negative financial guidance. The entire meeting on October 31st lasted between 15 and 30 minutes, and the majority of the discussion concerned the new financial guidance, which was a complete shock to the outside Directors and some members of Management. The Board did not actually vote to adopt resolutions approving the Tracker stocks on October 31, 2000, but no one appears to have objected to Mr. Ebbers' statement that the Tracker stocks would be announced the next day. Despite this lack of a vote, the Press Release issued the next day stated that the WorldCom Board had approved the Tracker stocks.

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[40] The Board was notified on October 30, 2000 about the October 31st call but was not provided with an agenda.

The Examiner has several concerns about the foregoing process. First, the Examiner can discern no reason why the decision to create the Tracker stocks had to be announced on November 1, 2000, prior to any briefing of the Board by WorldCom's investment bankers, who already had conducted extensive analyses regarding the Tracker stocks. In the case of the MCI and Sprint transactions, financial advisers made presentations to the Board in advance of Management's request that the Board make any decisions. The Examiner cannot understand why Management would seek to have the Board reach a final decision on the creation of the Tracker stocks without hearing from advisers who ultimately were paid a total of $7 million.[41] In short, Management's and the Board's decision-making on the Tracker stocks did not reflect careful strategic planning. Rather, in the words of one Director, the Tracker stocks were merely the "flavor of the month."

Second, the Examiner concludes preliminarily that the WorldCom Board failed to become reasonably informed of all relevant data before agreeing to the Tracker stocks. The Board never received any written data regarding Tracker stock issues, and a single executive session on September 7, 2000 to discuss Tracker stock issues simply did not provide enough time for the Board to become informed before approving the creation of the Tracker stocks. Likewise, Management failed in its obligation to provide relevant data to the Board. This is another example of the passive WorldCom Board permitting Management to take significant action when and as it liked. Deciding to proceed with the Tracker stocks in this manner is inconsistent with the duty of care obligations of the Board and Management.[42]

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[41] Although Mr. Salsbury was the General Counsel of WorldCom, he did not see it as his role to suggest that investment bankers make presentations before the Tracker stocks decision was made.

[42] One Director candidly informed us that he did not know much about the Tracker stocks until December 2000, when the Board received the preliminary Tracker stocks proxy statement.

Third, the Examiner is troubled by the lack of meaningful deliberation by the Board and Management in connection with the Tracker stocks. As noted, no Board votes were taken at the September 7 or October 31, 2000 Board meetings and the notice provided to the Board of the October 31st meeting expressly stated that the meeting was informational. Thereafter, however, following discussions among Messrs. Sullivan, Borghardt, Salsbury and outside counsel, it was decided to convert the October 31st informational meeting into a formal Board meeting, complete with minutes that contained resolutions approving the Tracker stocks dated October 31, 2000. These "minutes" were thereafter approved by the Board without discussion on March 1, 2001.

The "minutes" of the Board's October 31, 2000 conference call also reflect that the Board approved a Tracker Stock Policy Statement, setting forth the methods by which assets, debt and other interests would be allocated between the WorldCom Group and the MCI Group. This apparently was not the case. The Examiner views this as yet another indication of poor process and the WorldCom Board's lack of informed oversight with respect to the affairs of the Company. The Tracker stock allocations were an important matter under the Tracker stock structure, and it appears that the Policy Statement ultimately was "adopted" without any input from or substantive discussion with the Board.

d. Verizon

A further example of the Board's failure to guide WorldCom's strategic direction, and Management's failure to inform the Board fully with respect to a potential transaction, arose in November 2001. This time, the potential acquisition was that of WorldCom itself by Verizon.

During the November 2001 Board meeting, Mr. Ebbers disclosed that Verizon was interested in acquiring WorldCom for $21 per share. At that time, WorldCom's stock was trading at approximately $15 per share. At least some of the Directors favored such a plan, but they did not make their views known, because Mr. Ebbers apparently insisted on an offer of at least $30 per share. Neither Management nor any Director suggested that an investment banker be engaged to review the Verizon proposal.

It is not clear whether a Verizon takeover could have succeeded, given potential regulatory issues. The Examiner believes, however, that Management should, at a minimum, have discussed the potential acquisition with the Board in some detail and should have considered whether to engage outside advisers. Notwithstanding Management's failure to inform the Board adequately, the Board's companion failure to inquire further or take action is another example of its passivity and its failure to carry out its responsibility to oversee the Company's affairs on an informed basis.

5. Acquisition Integration

Acquisitions present the potential for substantial benefits. They also carry the potential for great risk, particularly when billions are invested based upon anticipated synergies and cost savings. It is for that reason that the Examiner has investigated the success of WorldCom in integrating various acquired assets and businesses.

At the outset, the Examiner stresses that assessing the success of acquisition integration is highly subjective. In the best of circumstances, it is difficult to find measurements for the success of integration efforts. The Examiner therefore has had to rely to a large degree upon the views of present and former WorldCom personnel whom we have interviewed. It has been widely asserted in the media and elsewhere that very little effort was made at WorldCom to carry out effective integration activities and that integration of acquisitions was therefore very much lacking. The Examiner's preliminary conclusion is that these assertions are accurate.

First, the WorldCom Board paid very little attention to issues pertaining to integration of acquisitions into WorldCom. That is not to state that Management's periodic operating reports to the Board did not address integration issues, but that the Examiner's overall impression is that the Board devoted very little time to integration issues. Such a conclusion has been confirmed by the interviews that the Examiner has conducted.

Second, WorldCom Management made some efforts to integrate acquisitions, but the overall results were highly mixed. This may reflect the apparent absence by Mr. Ebbers of an interest in integration and his attitude was subtly and not so subtly communicated throughout the Company. Indeed, one former member of Management stated that Mr. Ebbers ran WorldCom as if it were a "7-11."

Integration seems to have worked best when integration measures were purely mechanical, such as connecting one network with a non-overlapping network of an acquired company. The integration of the Brooks Fiber CLEC network in secondary markets into the MFS CLEC network in major markets, for example, appears to have been relatively successful. Integration of overlapping systems, such as parallel networks, billing systems and computer systems, was far less successful. Substantial effort and a considerable amount of money was spent on integration, but the overall success seems limited.

The chief reasons for the failures to eliminate overlapping systems and to achieve expected cost reductions appear to be cultural. WorldCom developed its own style over time and the Company's general approach was to instruct acquired companies to adjust to the WorldCom style, like it or not. This led to substantial difficulties, particularly in the MCI acquisition, during the course of which WorldCom and MCI officers and employees developed real and lasting animosities. These animosities, in turn, led to outright refusals to work cooperatively to eliminate redundant systems and to achieve substantial cost reductions.

Third, efforts to achieve synergies also seems to have been lacking due to cultural difficulties. WorldCom Management envisioned that following the Intermedia acquisition, the

WorldCom Internet sales force, which came mostly from UUNET, would work with the Digex sales force to sell Digex's managed Web hosting services to WorldCom clients. This proved almost totally unsuccessful, for a variety of cultural reasons. The UUNET sales force had never been effectively integrated into WorldCom in the first place and proved reluctant to seek to market the Digex services with the Digex sales force. Further, the UUNET sales force had little training in the marketing of managed Web services. Finally, the WorldCom sales force customer contacts were mostly with telecommunications personnel, while the Digex products were mostly sold through information services contexts. Predicted synergies, therefore, were very hard to achieve.

The integration of acquisitions also was impeded by the decentralization of WorldCom Management. By way of example, Mr. Ebbers was in Mississippi; Mr. Sullivan divided time between Florida and Mississippi; Mr. Salsbury was in Washington, D.C.; Mr. Borghardt was in St. Louis; Mr. Beaumont was in Texas; and the Company's Human Relations Department was managed from Florida. It is not difficult to understand why integration of acquisitions would be difficult with such a structure. Under these circumstances, it is not surprising that one former member of Management described WorldCom's management structure as "dysfunctional."

The Examiner has been informed that over the past three to six months, the progress of integration has improved markedly. In part, this may be because in a bankruptcy context, it is easier to avoid or eliminate redundant contracts. However, we also have the sense that a determined effort to achieve cost savings and efficiencies has been put in place and that current senior Management has forcefully communicated the importance of that effort, something that did not exist in prior years.

D. The Tracker Stock Allocations

The Examiner is examining issues pertaining to the allocations of assets, liabilities, revenues and expenses between the WorldCom Group Tracker stock and the MCI Group Tracker stock.[43] The Examiner's investigation of this issue is preliminary, but it is nevertheless appropriate to identify some issues that may be significant.

Both in the resolutions purportedly adopted by the WorldCom Board on October 31, 2000 and in later securities filings (the Form S-4 and the subsequent proxy), WorldCom represented that allocation issues would be resolved in a manner that was determined to be in the best interests of the Company as a whole. The Examiner's initial investigation into this matter suggests that WorldCom may not have followed its own guidance. Mr. Sullivan appears to have made virtually every significant allocation decision with a bias toward allocations that benefited the WorldCom Group and that had a corresponding negative impact upon the MCI Group.

Several Tracker stock allocation decisions are difficult to understand. The MCI Group was to be allocated no cash balances, for example, even though it was the group that produced the greatest cash flow. Instead, all cash balances were to be allocated to the WorldCom Group. Similarly, all tradenames, including MCI's own tradename, were attributed to the WorldCom Group, and the MCI Group was charged a fee ($27.5 million in 2001 alone) for the use of those tradenames. There may be tax-related reasons for all intangible assets to be allocated to one entity, but the resulting fees charged seem questionable. Further, the MCI Group was allocated

[43] Under the WorldCom Tracker stock plan, WorldCom was divided into two separate groups for stock exchange listing purposes. The WorldCom Group Tracker stock contained the high growth portions of the Company (data, Internet, Web hosting and international), while the MCI Group Tracker stock contained the slower growth but higher cash flow businesses (consumer and small business, long distance, paging, voice and dial-up Internet). It was felt that by dividing the Company in this manner for stock listing purposes, investors would more clearly see the values inherent in each group, resulting in enhanced value of Company stock.

$6 billion of long-term debt, which seems high, given that MCI had less than $5 billion of long-term debt at the time the MCI acquisition closed in September 1998.

The Examiner recognizes, however, that Tracker stock allocation issues are highly complex. The Examiner is still reviewing these issues. At this time, the Examiner makes no preliminary findings with respect to these issues beyond expressing the view that further investigation is required.

E. Acquisition Accounting Issues

As part of his investigation of WorldCom's accounting irregularities, the Examiner has monitored the efforts of the Company to identify material acquisition-related accounting issues. Its efforts, assisted by DoveBid, Inc. a provider of valuation services, are ongoing. To avoid cost duplication, the Examiner's forensic accountants, J.H. Cohn LLP, thus far have refrained, for the most part, from undertaking independent analyses of acquisition accounting issues. Until the Company completes its efforts, the Examiner cannot reach any firm conclusions with respect to acquisition-related errors or misstatements.

Through the monitoring process, however, the Examiner has identified a number of accounting issues in connection with WorldCom's acquisitions. In their most general terms, these issues include the following:

- Whether WorldCom accounted for its mergers, acquisitions, and outsourcing transactions in accordance with GAAP;
- Whether acquisition-related reserves were appropriately created and whether they subsequently were appropriately maintained and/or released;
- Whether the valuation analyses and fair value measurements that WorldCom used in its purchase price allocations were appropriate;
- Whether the useful lives that WorldCom assigned to the intangible and tangible assets of acquired companies were reasonable; and

- Whether WorldCom appropriately classified acquisition-related costs as capital assets or expenses.

We discuss WorldCom's acquisition reserves and valuation analyses below.

1. Acquisition Reserves: The Role of Acquisition Reserves in Purchase Accounting

The Examiner is reviewing WorldCom's use of the reserves established in connection with various acquisitions. In purchase accounting, acquiring companies frequently establish reserves – or accrued liabilities – with respect to assets and probable liabilities of the acquired company. WorldCom established billions of dollars of such reserves in connection with its numerous mergers and acquisitions. These reserves were for, among other things:

- severance payments to terminated employees of acquired companies;
- costs, such as lease termination costs, that WorldCom expected to incur in closing facilities of acquired companies;
- unfavorable contractual and other commitments of acquired companies, obligating them to pay, for example, above-market rents or prices for goods and services;
- assets that permanently had declined in value (known as "impaired assets") due to WorldCom's business intentions with respect to these assets;
- liabilities arising from lawsuits and other legal matters; and
- taxes.

Unlike most reserves, which are established through charges against expenses in a company's income statement, acquisition reserves generally are established by an offsetting increase to goodwill. To the extent that there is a need to refine the purchase price allocations during the one year allocation period, such adjustments are recorded by increasing or decreasing the value of an asset or liability with an offsetting adjustment to goodwill. Subsequent to the one year allocation period, to the extent that the acquisition reserves are determined to be excessive, they are reversed, resulting in increased earnings. To the extent that the acquisition reserves are determined to be inadequate, additional amounts required for the reserves are reflected in the expense category on the company's income statement.[44]

One way in which companies can manipulate their earnings is by establishing excessive acquisition reserves as part of their purchase accounting. As we have noted, acquisition reserves are generally established through increasing the amount of a company's goodwill. Until January 1, 2002, a company's goodwill was charged to the expense category of its income statement in increments over a period of up to 40 years.[45] Therefore, until recently,[46] it was possible under GAAP for a company to release an excess acquisition reserve a few years following the acquisition and to receive a current earnings benefit; the related goodwill would be expensed over an extended time period. This created the possibility that a company could establish sizeable and unjustified acquisition reserves so that it would have a "cookie jar" of reserves to release at times when its actual earnings declined, enabling the company to boost its apparent earnings to meet the expectations of financial analysts.

2. Valuation Issues in Purchase Accounting

The Examiner also is investigating whether WorldCom, in addition to using acquisition reserves in this "cookie jar" fashion, might, without sufficient justification, have reduced the book value of the tangible assets of some of the companies that it acquired, including MCI, while commensurately increasing the amount allocated to goodwill. By doing so, WorldCom could

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44 Statement of Financial Accounting Standards No. 38, Accounting for Pre-Acquisition Contingencies and Purchase Enterprises, paragraph 6.

45 Accounting Principles Board Opinion No. 17, Intangible Assets, paragraph 29.

46 As of January 1, 2002, the Financial Accounting Standards Board changed the goodwill rules to eliminate goodwill amortization. Instead, on an annual basis, a company must perform an impairment review of its goodwill.

improperly have amortized the reallocated value of such tangible assets (which had relatively short useful lives) over a far longer period. The effect of such a practice would have been to enhance reported earnings on a continuing and artificial basis. If WorldCom engaged in this type of manipulation, the Company would have had incentives to "keep the acquisition game going," whether or not particular acquisitions were justified from the standpoint of corporate strategy.

The Examiner continues to review the valuation analyses and fair value measurements that WorldCom used in its purchase price allocations. Preliminary analyses suggest that, in light of the data that Arthur Andersen relied upon, the methodologies that it used, and its ultimate analysis in each case, Arthur Andersen's valuation reports for the MFS, WilTel, AOL and MCI transactions may not have been reasonable.

F. Concluding Observations on Strategic Planning and Acquisitions

The Examiner's preliminary conclusions on WorldCom's strategic planning and acquisitions have, to a great extent, already been stated in this Chapter. However, several additional observations are appropriate.

First, a number of Directors contended that the WorldCom Board was not afraid to confront Management and that it was not a "rubber-stamp" for Mr. Ebbers. The Examiner does not agree. For much of the 1997-2002 period, the Board appears to have been highly deferential to Management on strategic planning and acquisitions matters, which may be understandable given WorldCom's sound track record through 1999. But, the Examiner cannot condone the Board's acquiescence in the increasing paucity of information furnished to it regarding important decisions in 1999-2001 and the Board's failure, in particular, to confront Management about the seriously deficient due diligence and approval processes employed in the Intermedia transaction.

The Examiner accepts that a number of Directors felt that they were assertive and stood up to Management, particularly since the outside Directors forced Mr. Ebbers' resignation in

2002. The Examiner concludes, however, that there is no reasonable explanation why the Directors waited so long to take action, given the events that occurred in 2000-2001, particularly those regarding Intermedia. One Director was quite forthright when asked whether the Board on March 1, 2001 had rubber-stamped Management's decision to continue with the Intermedia merger. He replied "yes." He further stated: "It was stupid and costly. Bernie was the man; Sullivan was the man behind the man; this was one big boo-boo." Thus, the Examiner preliminarily concludes that the Directors had become ineffectual and a rubber-stamp for Management, thereby failing to meet their fiduciary duties.

Second, the Examiner does not ascribe bad faith to this apparent fiduciary lapse. Many of the Directors were significant investors in WorldCom and ultimately saw their investments wiped out. Rather, this lapse reflect a pattern and practice whereby the Board made decisions based on whatever information Management chose to present, even when minimal, regarding very significant investments by WorldCom.

Third, the Examiner is troubled by the fact that in 2000 and 2001, particularly in the context of the Intermedia transaction, and also in the case of the Tracker stocks, the Board received and sought little or no advice from external advisers about how to proceed. The Examiner preliminarily believes that it should have been apparent to the Directors that these were major decisions as to which the Board was getting very little information and critical analysis. Many of the Board members were sophisticated in the telecommunications industry and their acquiescence in this apparent paucity of information is perplexing.

The Examiner recognizes that he must analyze these issues from the perspective of the time frames in question, rather than with hindsight. Even from that perspective, the Examiner has substantial questions regarding whether the Board and Management and their advisers were meeting their responsibilities in 2000 and 2001.

Fourth, the Examiner has identified in this Report numerous instances in which questionable corporate governance practices were followed, including the failures to supply adequate information to the Board before it took significant corporate action. These lapses also include the failure of any investment bankers to address the Board on Tracker stock issues and the failure to obtain Board approval, on the basis of sound analysis of available information, before the amended Intermedia merger agreement was executed.

The Examiner believes that in most corporate contexts, counsel would have responsibility for advising the Board and Management on the proper corporate governance practices. Further, counsel would be expected to provide warnings of possible risks when the Board was asked to act with such a small amount of data and with little opportunity to analyze the proposed action. At WorldCom, however, no counsel appears to have seen that as his responsibility. The two in-house lawyers who had the greatest contact with the Board, Messrs. Salsbury and Borghardt, each informed us that he did not view it as his responsibility to advise the Board and Management on such matters.[47] Similarly, it seems apparent that only on the mega-transactions (MCI and Sprint) did outside counsel advise the Board on the information required and the process for reviewing that information. On other transactions, except for Intermedia, they did not attend Board meetings. This issue merits further investigation.

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47 Mr. Salsbury informed the Examiner that he believed that it was Mr. Borghardt's responsibility to advise the Board on corporate governance issues with respect to the matters of the Corporate Development Department.

V. DEBT OFFERINGS AND USE OF CREDIT FACILITIES

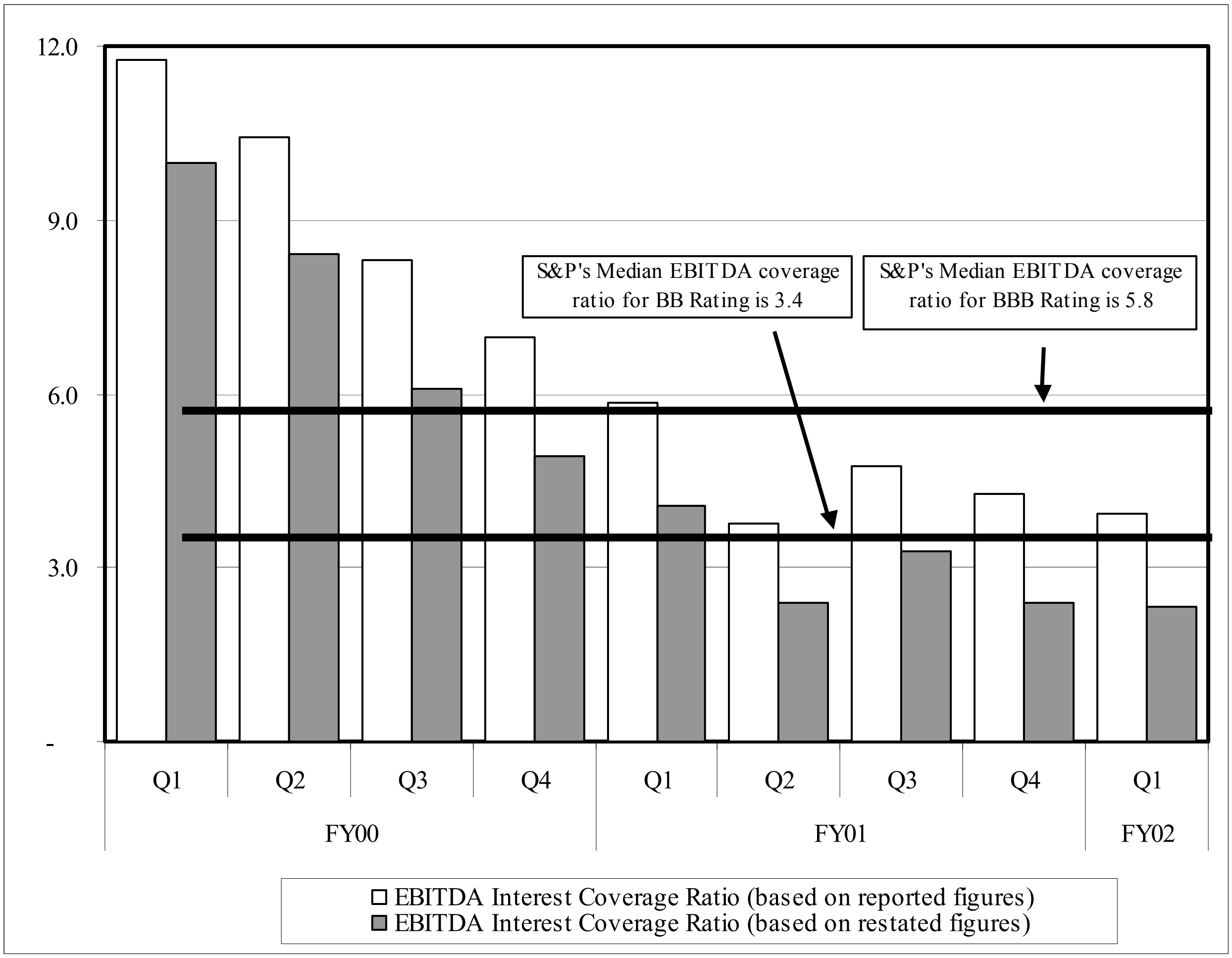
A. Introduction

At the same time that WorldCom was perpetrating a fraud on the public by capitalizing line costs and inappropriately releasing reserves, it was also borrowing vast amounts of money from financial institutions and public investors. The accounting fraud allowed the Company to present a rosier financial picture than the Company could have otherwise presented, which presumably enabled the Company to sell more debt securities to the public and secure larger credit facilities from lenders. The fraudulent accounting essentially induced WorldCom's investors and lenders to invest in the Company because they perceived the Company to be "investment grade" and creditworthy. By July 2002, the Company had secured more than $36 billion of bank and bond debt, which constituted approximately 88 percent of its total debt at the time it filed for bankruptcy protection.

The Company's fraudulent accounting practices essentially stymied some of the usual external controls on the accumulation of debt. Generally, investors and lenders serve as external controls on a company's ability to accrue debt because, with accurate financial information, investors and lenders are able to judge whether a company is investment worthy. Specifically, public investors rely on accurate financial information to make investment decisions with respect to the purchase of debt securities. Similarly, lending institutions rely on accurate financial information to make lending decisions with respect to a company. WorldCom's failure to provide accurate financial information evaded the normal system of external checks and balances and rendered the market unable to determine accurately the Company's ability to support its debt load. However, as discussed later in this Chapter, the fraudulent accounting practices were just one of many problems with the Company's debt offerings and lines of credit.

The Company's fraudulent accounting scheme operated to mislead the rating agencies which issue credit ratings, that are intended to reflect the creditworthiness of a company with respect to both specific and general financial obligations. Investors and lenders rely on the ratings assigned by rating agencies in making investment and lending decisions. In rating a company's creditworthiness, one of the key factors relied upon by the rating agencies is a company's interest coverage ratio, which compares a company's earnings from continuing operations before interest, taxes, depreciation and amortization ("EBITDA") against gross interest incurred before subtracting capitalized interest and interest income (the "EBITDA Interest Coverage Ratio").

WorldCom's accounting fraud artificially inflated the Company's EBITDA, which is often times an indicator of the Company's ability to service its debt from its cash flow. In turn, the inflated EBITDA made the Company's EBITDA Interest Coverage Ratio more attractive to the rating agencies and made the Company appear to be more creditworthy. The chart that follows demonstrates that the Company's manipulation of the EBITDA Interest Coverage Ratio likely influenced the rating agencies to assign a higher rating to the Company than would have been assigned given accurate financial information.


12.0
9.0
6.0
3.0
-
S&P's Median EBITDA coverage ratio for BB Rating is 3.4
S&P's Median EBITDA coverage ratio for BBB Rating is 5.8
Q1
Q2
Q3
Q4
Q1
Q2
Q3
Q4
Q1
FY00
FY01
FY02
EBITDA Interest Coverage Ratio (based on reported figures)
EBITDA Interest Coverage Ratio (based on restated figures)

As the chart demonstrates, the artificially inflated EBITDA Interest Coverage Ratio helped WorldCom secure an investment grade rating of at least "BBB" in both the fourth quarter of 2000 and the first quarter of 2001. In reality, the Company's true EBITDA Interest Coverage Ratio was more in line with companies that received a non-investment grade rating of "BB" for both periods. A company with a "BB" rating is viewed as having speculative characteristics. In other words, had the rating agencies known of the Company's actual financial situation, the Company may have been viewed by investors as being unable to meet its financial commitments under adverse business, financial or economic conditions.

Although it is impossible to determine precisely the actual effect of the skewed ratings, it is clear that investors and lenders would not have allowed WorldCom to undertake the largest unsecured bond offering ever by a U.S. company in May 2001 if the Company had a BB, or non-investment grade, rating. The Company simply was not as creditworthy as it purported to be. Moreover, it is questionable whether the Company could have renegotiated $4.25 billion of its unsecured credit facilities in June 2001. At the very least, it is likely that the Company would not have been able to incur its debt as easily and cheaply without the artificially inflated ratings.

In the years preceding its bankruptcy, the Company's preferred form of financing was its short-term commercial paper program.[48] Whenever its outstanding commercial paper reached the maximum level that the market could bear, the Company would issue debt securities, then use the proceeds from the issuance and sale of those debt securities to redeem the commercial paper. After each such redemption, the Company would typically return to the commercial paper market to fund its daily operating expenses. Given the true financial condition of the Company, which was masked by the improper accounting practices, the debt continued to rise to meet the

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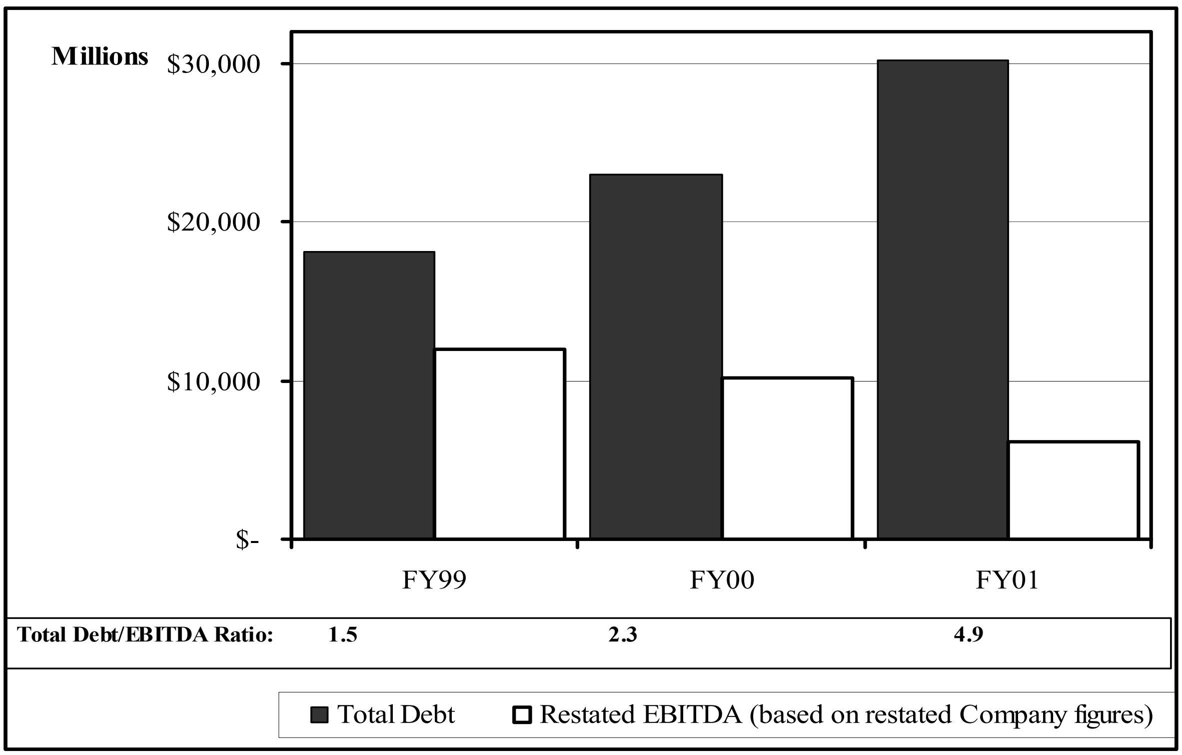
[48] Commercial paper is typically short-term promissory notes issued to investors either directly or through dealers. The notes are payable to the bearer on a stated maturity date, usually sixty days or less.

Company's operating cash flow needs. Meanwhile, the Company's actual EBITDA, which as previously stated is often times an indicator of the Company's ability to service its debt from the cash flow of the business, continued to decrease. The chart below demonstrates this trend.



By 2002, as a result of this long-standing practice of refinancing short-term debt with long-term debt, WorldCom found itself with more than $36 billion in bank and bond debt. When the accounting fraud was disclosed, WorldCom reached a point where it could not obtain any additional financing to service this debt. Therefore, the Company was faced with no other viable option but to declare bankruptcy.

As the Company continued to accumulate debt, the Board failed to institute any meaningful internal controls on the amount of debt the Company could accumulate. To the contrary, instead of limiting the amount of debt that Messrs. Ebbers and Sullivan could cause the Company to incur, the Board granted Messrs. Ebbers and Sullivan the unfettered discretion to issue an essentially unlimited amount of debt. Without any internal controls or external constraints, the Company's debt spiraled out of control and ultimately led to the Company's bankruptcy.

By spring of 2002, those familiar with the Company's cash position knew that the Company was in a precarious financial posture. Moreover, the financial condition of the Company had eroded to the point where it had become obvious that WorldCom's practice of issuing commercial paper and debt securities to cover operating expenses was no longer a viable financing option. Thus, on May 15, 2002, as a result of these and other factors, the Company suddenly announced its intention to borrow $2.65 billion under its 364-day revolving credit facility.[49] This was the first time in the Company's history that it was forced to rely on its line of credit facilities for cash. Approximately two months later, the Company filed for bankruptcy

[49] WorldCom had several different credit facilities, one of which was established under a 364-Day Revolving Credit Agreement, dated as of June 8, 2001, among the Company and 27 lenders, pursuant to which the Company had the ability to borrow up to $2.65 billion if the Company satisfied certain conditions.

protection. Its debt included both the $2.65 billion from the credit facility and approximately $34 billion in additional outstanding bank and bond debt.

B. WorldCom's Debt Offerings: 1998 - 2001

WorldCom issued over $25 billion worth of debt securities through both public and private offerings in the four years preceding its descent into bankruptcy.[50] While the amount of debt was itself staggering, these debt offerings also appear to have occurred with virtually no strategic planning and no internal process controls. First, the Company seems to have engaged in debt financing without any meaningful long-term plan for the incurrence, management or repayment of its debt. Second, the Company's Board granted just two individuals – Messrs. Ebbers and Sullivan – almost total control over its debt offerings by appointing them the sole members of the Company's pricing committee (the "Pricing Committee"). Third, the Company exhibited what can charitably be described as a lax approach toward the actual process of issuing debt, including the due diligence process, the drafting process, the staffing of the debt offerings, and the selection of underwriters.

1. Lack of Debt Planning

It appears that WorldCom's breathtaking expansion in the mid- to late-1990s may have occurred without the Board or Management giving any considered thought to WorldCom's fast-multiplying debt load. While Mr. Sullivan and others made presentations to the Board regarding the Company's financial condition, the Board spent little, if any, time discussing or examining the Company's increasing accumulation of debt, even during meetings occurring immediately before and immediately after a debt offering. Although certain Directors told the Examiner that

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[50] The specific offerings are: an August 11, 1998 public offering of $6.1 billion in debt securities; a May 24, 2000 public offering of $5.0 billion in debt securities; a December 19, 2000 private placement of $2.0 billion in debt securities; and a May 9, 2001 Public Offering of $11.9 billion in debt securities.

Mr. Sullivan's financial presentations included debt projections, the Examiner has found no evidence that the Company's Management or the Board spent any significant time evaluating projections or models assessing whether the Company could sustain the vast amount of debt it was incurring. Indeed, according to one former Board member, the Board never received projections regarding the Company's long-term debt nor did any Board member ever request such information.[51]

Other than a reference in a document entitled "Strategic Plan 1999-2003,"[52] the Examiner has yet to uncover any evidence of any strategic debt planning by the Company. In fact, the Company's former director of financial planning was under the impression that the Company's senior Management was not interested in strategic planning and that Mr. Ebbers in particular did not believe in strategic planning. A well-developed strategic plan could have helped the Board and Management understand and monitor the Company's debt accumulation. It also could have encouraged an analysis of the Company's future debt obligations. Any substantial deviation from that plan could have led the Board or Management to establish internal controls limiting additional debt accumulation. Thus, an effective strategic plan could have served as a check on debt accumulation.

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[51] The Examiner has received conflicting reports concerning the amount of information provided to the Board with respect to debt offerings. Two Board members stated that the Board saw projections and presentations with respect to each offering. However the Minutes from the Board meetings held prior to the Company's debt offerings do not reflect any discussion of these offerings, even where the Minutes mention that Mr. Sullivan provided a summary of the Company's debt.

[52] This Strategic Plan projected the Company's total debt in 2002 to be $9.9 billion, when, in fact, WorldCom's total debt outstanding as of March 31, 2002 was $29.3 billion.

2. Lack of Internal Controls Over Debt Accumulation: The Concentration of Authority

The WorldCom Board appears to have played a very limited role in the Company's debt offerings, and its failure to implement any effective internal controls typifies the Company's lax approach to its debt offerings. WorldCom's debt offering processes generally followed the same pattern. First, Management would determine the amount of debt that it wanted to have available to issue. Second, Management would circulate either a draft action by written consent (in lieu of a formal Board meeting) or a draft resolution to be adopted at a Board meeting. Third, the Board would authorize the issuance of the debt securities apparently without question and, in doing so, essentially abdicated all of its power and responsibility with respect to the debt offerings to the Company's "Pricing Committee," which consisted solely of Messrs. Ebbers and Sullivan.

a. Overview of the "Evergreen" Written Consent

The written consent authorized by the WorldCom Board effective as of March 31, 2000 (the "Written Consent") is a particularly egregious example of the Board's pattern of rubber-stamping Management's debt offering proposals. In this Written Consent, the Board approved and authorized the Company "to *maintain* an unused availability of up to $15 billion aggregate principal amount of debentures, notes, bonds" or other debt securities. In other words, the Company could repeatedly issue up to $15 billion in debt securities as Management saw fit without ever having to return to the Board and without ever having to pay off any of the previously issued debt securities. Thus, so long as the market could bear it, the Written Consent gave the Pricing Committee the authority to issue $15 billion of debt securities on a daily basis without having to obtain specific Board approval for each offering. Management referred to this Written Consent, and the powers created thereunder, as a perpetual, or "evergreen," Board authorization. As the following sections of this Chapter will show, both the Written Consent itself and the manner in which it was adopted illustrate the almost complete discretion that Messrs. Ebbers and Sullivan enjoyed in running up WorldCom's debt.

b. The Board's Failure to Discuss the Evergreen Written Consent

The Board authorized the repeated issuance of up to $15 billion of debt securities by written consent rather than at a full meeting at which the Board members could have discussed the contemplated action. Actions by written consent, which usually require unanimous board approval, are typically reserved for non-controversial and relatively insignificant matters that merit no formal board meeting.[53] The WorldCom Board historically had authorized the issuance of debt securities by written consent. However, the authorization of the continuous availability of $15 billion of debt securities was quite different and presumably should have warranted extensive discussion at a Board meeting. To date, the Examiner has found no credible evidence that the authorization of this substantial amount of continuous debt generated substantive questions from, or discussion by, the Board.

c. Management's Failure to Explain the Evergreen Written Consent

The Board's cavalier treatment of the Written Consent may be explained, in part, because the evidence reviewed to date suggests that the Board approved this Written Consent without an adequate explanation of its true nature. Although there is conflicting evidence on this point, one former Board member was quite surprised by the suggestion that the Board empowered the Pricing Committee to repeatedly issue up to $15 billion of debt securities. After reviewing the language of the Written Consent in an interview, however, this former Board member agreed that the Written Consent created this "evergreen effect," a result he attributed to poor drafting. According to this former Board member, he believed the Board intended to set a fixed amount of

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53 Model Bus. Corp. Act § 8.21 (2001).

debt securities that the Pricing Committee could issue. Although communications between a member of Management and the Company's in-house counsel indicate that the Written Consent was deliberately drafted to create this "evergreen effect," none of the former Directors interviewed by the Examiner recalled any communications between the Board and Management about this aspect of the Written Consent.

d. The Pricing Committee's Absolute Discretion

In adopting the Written Consent, the Board granted the Pricing Committee the unfettered discretion to determine whether and when to issue debt securities. The Written Consent also gave the Pricing Committee full authority to establish all of the terms of any debt securities issued, including the amount, the price, and various other provisions of such debt securities. Members of the Board do not appear to have questioned whether it was prudent to give Management this unlimited authority. In fact, two former members of the Board have confirmed that the Board never considered whether the Pricing Committee should have included independent directors or whether the Board should have required substantive periodic updates on debt offerings. One of these former Directors explained that the Board did not discuss these issues, because such a discussion would have signaled that the Board did not have faith in Messrs. Ebbers and Sullivan.

e. The "Evergreen" Nature of the Written Consent

As noted above, the Board gave the Pricing Committee the power to issue repeatedly up to $15 billion of debt securities by using the words "*maintain* an unused availability of up to $15 billion…of debt securities." This language in the Written Consent is markedly different from most resolutions authorizing the issuance of debt securities, including the resolutions previously executed by the WorldCom Board. In most instances, a board of directors authorizes the company to issue a fixed amount of debt securities. Once the company exhausts that fixed amount, the board must approve any additional issuance.

WorldCom followed this same practice until March 31, 2000, when the WorldCom Board executed the Written Consent, which gave the Pricing Committee the power to issue an unlimited amount of debt securities without ever having to return to the Board and without ever having to pay off any of the previously issued debt securities. Information provided to the Examiner appears to reflect that Mr. Sullivan intended to bestow this power upon the Pricing Committee and that he directed in-house counsel to draft a document that would authorize the Pricing Committee to have "$15 billion [of debt securities] available [for issuance] at all times even after" the Company issued any portion of the initial $15 billion of debt securities.

Although the Pricing Committee honored the alleged limitation on the Written Consent that did not allow the Company to issue more than $15 billion in debt securities at any one time, the members of the Pricing Committee must have interpreted the language of the Written Consent to grant them the discretion to cause the Company to undertake multiple debt offerings, which individually were for less than $15 billion but in the aggregate were for more than $15 billion. Thus, after the approval of the Written Consent, the Pricing Committee caused the Company to issue through two offerings approximately $17 billion in debt securities, apparently without receiving any additional Board approvals. At least two former Board members have indicated that there was no additional Board approval. Both stated that they had no recollection that the Board specifically authorized the issuance of any additional debt securities, and one of those Directors also suggested that he would not be surprised to learn that the Pricing Committee had issued additional debt securities without receiving specific Board authorization.

The unfettered discretion granted to the Pricing Committee strongly suggests that the Board paid little attention to the Company's debt offerings and that it simply deferred to Messrs. Sullivan and Ebbers on this significant issue. One former Board member claimed to have been unaware of the broad power granted to the Pricing Committee. Another former Board member informed us that he was aware of the broad power granted to the Pricing Committee but suggested that such broad power was necessary to allow the Pricing Committee and the Company to have immediate access to the funds it needed to undertake transactions. Regardless, the evidence suggests, at best, that Management did not adequately inform the Board about its debt offerings and, at worst, that the Board failed to implement any meaningful internal controls on the Pricing Committee. If the Board had not given the Pricing Committee such broad authority or if the Directors had placed meaningful controls on the issuance of debt, it is possible or even likely that a member of the Board or of Management would have questioned the Company's burgeoning debt load and stopped or slowed the Company's descent into bankruptcy.

3. Lack of Internal Controls: Process Failures

The Company's unfocused and casual approach to debt is further evidenced by the manner in which its debt offerings were undertaken. First, the debt offerings were managed internally by WorldCom personnel. Second, the underwriters were selected using criteria other than solely merit. Third, minimal due diligence was performed in connection with the debt offerings. Fourth, the investment risks associated with the debt offerings were not adequately disclosed to investors and lenders.

a. Personnel and Staffing Issues

A troubling aspect of WorldCom's accumulation of debt concerns the experience of the personnel responsible for managing the Company's December 2000 and May 2001 debt offerings, which totaled $13.9 billion. The employee primarily responsible for the $2 billion debt offering in December 2000 had never run a debt offering before, yet she single-handedly managed that offering from start to finish. Similarly, WorldCom's Treasurer, who was primarily responsible for the Company's $11.9 billion debt offering in May 2001, had no prior experience with debt offerings. Her lack of experience is particularly surprising given that the May 2001 offering was the largest domestic corporate debt offering ever.

b. Selection of Underwriters

Rather than selecting its underwriters solely on the basis of merit or other competitive criteria, the Company's Management relied on other factors when making its decisions, including (a) the amount of credit that the underwriters' commercial banking affiliates had extended or committed to WorldCom; and (b) the ratings that the underwriters' analysts had given to WorldCom. While this *quid pro quo* arrangement may be legally permissible, and may have been standard behavior by issuers in the market, in WorldCom's case, it may also have allowed the Company to incur more debt than might have been reasonable or justified, thereby increasing the number of claims against the Debtors.

i. Extension of Credit to WorldCom

It appears that WorldCom allocated its underwriting business to various underwriters based, in part, upon the amount of money that a particular underwriter's affiliate bank was willing to commit to the Company's credit facilities. The evidence indicates that the underwriters acknowledged and accepted this method of selection. For example, various internal communications included discussions of the Company's interactions with prospective underwriters, noting "[w]e told them that they would have to increase their commitment on the revolver significantly to play any role at all on the bond deal," and "I told [a securities firm] that a $300 million commitment [to the credit facility] was not going to get them a top slot [in the debt issuance]."

These communications, as well as other evidence, indicate that the Company put pressure on underwriters and their affiliate banks to extend credit in exchange for underwriting business. This "lend to play" approach may have enabled WorldCom to obtain larger credit facilities than it could have secured otherwise. As a result, these larger credit facilities may have weakened the position of all of the Company's creditors, including that of its public debt holders, by increasing the aggregate amount of debt outstanding when WorldCom entered bankruptcy.

ii. Ratings by Securities Analysts

In addition to considering willingness to extend credit in selecting underwriters, the evidence suggests that the Company also considered the ratings given to it by the underwriters' equity and debt research analysts. By considering analysts' ratings, the Company may have encouraged underwriters to breach their "Information Walls," which are internal communication barriers that are intended to prevent underwriters from sharing material, non-public information about their publicly-traded clients with others in their firms. This separation is necessary to ensure, among other things, that material non-public information is not leaked to the public through research analysts' reports. The Examiner has uncovered evidence demonstrating that the Company openly encouraged its underwriters to discuss WorldCom with their affiliate research analysts. For example, in considering whether to undertake a debt offering, Mr. Sullivan told an underwriter that "your head of debt research … gives me a very hard time when we access the market more than once in a year." The underwriter responded "I will talk to [him] and set him in the right direction." This correspondence suggests that the underwriter intended to affect the analysis of WorldCom's securities, and possibly the rating given by, the analyst.

In sum, the process by which WorldCom selected underwriters for its debt offerings suggests that the Company was concerned primarily with analyst ratings and with obtaining the largest credit facilities possible from the underwriter banks, not with the quality and expertise of the underwriters.

c. Omitting Risk Factors

An issuing company, its underwriters, and each of their legal counsel will typically spend a considerable amount of time drafting the debt offering documents. SEC regulations require that the offering documents contain "where appropriate . . . a discussion of the most significant factors that make the offering speculative or risky."[54] The purpose of the risk factors section is to put investors on notice that making an investment in the issuing company involves certain risks.[55] A thoughtful and thorough discussion of risk factors thereby protects both the company and its underwriters from securities claims by investors.[56]

While WorldCom's August 11, 1998, debt offering documents contained an eight page discussion of risk factors, WorldCom's subsequent debt offering documents conspicuously omitted a risk factors section. Both the Company's Management and outside corporate counsel knew about the omission of risk factors. However, in-house counsel did not recall discussing whether risk factors should be disclosed, and in our interviews, did not seem concerned about the lack of any risk factors discussion in the subsequent offering documents. Furthermore, the Company executive with the most substantial involvement in the May 2001 debt offering also did not remember any discussion of whether risk factors should be disclosed. In fact, she informed us that she was surprised to learn that risk factors were not included in the Company's

[54] Item 503(c) Regulation S-K.

[55] Practicing Law Institute, Risk Factors Disclosure and the Private Securities Litigation Reform Act (October 2002) (stating that "risk factors disclosure can be seen as the inclusion of specific passages of text that are intended to highlight for the reader particularly significant risks that may be associated with an investment in the issuer's securities").

[56] In re Worlds of Wonder Securities Litigation, 35 F.3d 1407, 1416 (9th Cir. 1994) (holding that risk disclosure was sufficient to defeat plaintiff's securities fraud claims at summary judgment).

May 2001 offering documents, because she believed that disclosure of risk factors is a fairly standard practice.

As noted, the SEC requires a discussion of risk factors only "where appropriate," and, admittedly, issuers with a history of stable and predictable revenues may conclude that disclosure of risk factors is not necessary. WorldCom's risk profile, however, leaves little doubt that a risk factors section would have been "appropriate," because:

- the Company was still funding part of its operations and capital expenses with borrowed money;
- the Company recently had problems placing its commercial paper;
- the Company was not cash-flow positive;
- the Company had to renegotiate its credit facilities;
- the Company had recently acquired numerous businesses that needed to be fully integrated into the Company; and
- the Company's stock, along with the stock of other companies in the telecommunications sector, was under-performing.

Consequently, a WorldCom offering was hardly an "appropriate" candidate for excluding a risk factors disclosure section in the prospectus.

C. The Credit Facility Drawdown and Conversion

In the few years leading up to its bankruptcy, WorldCom engaged in inadequate strategic planning with regard to its debt offerings, accorded virtually unfettered discretion to Messrs. Ebbers and Sullivan in this area, and employed a debt offering process riddled with procedural flaws. Due to its rapid accumulation of huge amounts of debt – both public and private – WorldCom, by early 2002, was left with few alternatives for financing its day-to-day operations, one of which, discussed below, created its own set of problems for the Company.

1. Background

The Company's attitude toward debt accumulation changed suddenly when it realized that it had exhausted proceeds of the May 2001, $11.9 billion debt offering in about eight months. WorldCom originally believed that the proceeds would last 18 months. As early as February 2002, Management, including Messrs. Ebbers and Sullivan, became extremely concerned about the Company's cash position when they learned of the rapid exhaustion of the $11.9 billion.

Indeed, the Company had recently reported that it was "cash flow positive" for the fourth quarter of 2001 and for the first quarter of 2002. The Company also was attempting to make its cash position appear to be stronger than it actually was by withholding payments on outstanding bills from the end of each fiscal quarter until the beginning of the next fiscal quarter, thus giving the appearance of higher cash balances at the end of each quarter. While not an unusual practice, this withholding of payments may have artificially inflated the appearance of the Company's cash position to the public.

Part of Management's concern about cash stemmed from the Company's history of consuming more cash than its operations generated (its "burn rate"). Even though the Company was announcing that it was cash flow positive at the time, the Company's records appear to indicate otherwise. As of January 31, 2002, the outlook for the Company was problematic, considering that the records demonstrate that the Company had less than $400 million in available cash and that the Company needed $200 to $300 million in order to satisfy its monthly burn rate. Given the Company's historical burn rate, and assuming that the Company's operational revenues and expenses remained constant, the amount of cash that WorldCom had on hand as of January 31, 2002 would have lasted only two to three months. The Company's tenuous cash position apparently prompted WorldCom to give 27 lender banks ("the Lenders," or, individually, "a Lender") notice of its intent to draw down its $2.65 billion 364-day revolving credit agreement on May 15, 2002.

2. Drawing Down on the 364-Day Revolving Credit Agreement

a. The Terms of the Credit Agreement

On June 8, 2001, the Company entered into a $2.65 billion, 364-day revolving credit agreement (the "Credit Agreement") with the Lenders.[57] The Credit Agreement was a revolving credit facility, which allowed WorldCom continually to borrow and repay up to $2.65 billion, until the expiration of the facility on June 7, 2002. If the Company borrowed any funds on or before June 7, 2002, it could extend repayment of those funds for an additional term of one year by converting the revolving loan into a term loan.

The Credit Agreement served two purposes: (a) it was a back-up facility for the Company's commercial paper program; and (b) it provided a supply of cash for emergency situations. Because the Credit Agreement was a back-up facility, WorldCom had little expectation that it would ever be used.

The Credit Agreement required that the Company certify its compliance with the Agreement's terms in at least three circumstances, each of which required an executed Compliance Certificate from the Company: (a) periodically, in connection with the delivery to the Lenders of the Company's quarterly and annual financial statements; (b) whenever the Company sought to borrow (or "draw down") funds under the credit facility; and (c) when the Company wanted to convert the credit facility into a term loan under the Credit Agreement's conversion provisions. The Company's Treasurer executed many of the documents required for general compliance under the Credit Agreement.

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57 Mr. Sullivan has been indicted by the United States Attorney for the Southern District of New York for his role in securing the Credit Agreement using allegedly fraudulent financial statements.

b. WorldCom's Position on the Facility: External v. Internal

Until May 15, 2002, when the Company announced its decision to draw down under the Credit Agreement, the Company's public statements gave the impression that the Company was not planning to borrow funds under any of its credit facilities. For example, in a May 9, 2002 analyst conference call, Mr. Sullivan stated that "[t]oday, the company has zero commercial paper out there . . . *undrawn facilities, and that's pretty much what our intention is going forward*."

Despite the Company's public statements, however, WorldCom executives had been discussing for some time the possibility of drawing down the $2.65 billion credit facility. For example, as early as February 11, 2002, the Company's Treasurer discussed with one investment bank the potential repercussions of drawing down credit facilities and relayed such information to Mr. Sullivan. Again, on April 10, 2002, members of the Treasury Department discussed borrowing funds under the Credit Agreement and using the proceeds to refinance the Company's outstanding debt securities. By late April several Company executives knew that there was a "high probability" the Company would do so. On May 4, 2002, that "high probability" became even more certain when the Company's Treasurer anticipated that WorldCom would have to borrow funds under the Credit Agreement in order to satisfy certain upcoming payments.

Finally, in an analyst conference call on May 15, 2002, the Company announced its intention to draw down the entire amount available under the Credit Agreement. Shortly thereafter, the Treasurer executed and delivered to the lead administrative agent bank the various notices required to (a) draw down the facility; and (b) convert the facility into a term loan. These notices certified that WorldCom was in compliance with the terms of the Credit Agreement.

3. Problems With WorldCom's Compliance Efforts

a. Lack of Legal Review

The execution and delivery of the compliance certificates required a review and understanding of the provisions of the Credit Agreement from both a financial and a legal perspective. On the financial side, the Credit Agreement required the Company to meet certain financial tests. On the legal side, the Credit Agreement required the Company to monitor certain legal requirements, including whether any defaults existed under its material agreements and whether the Company was in compliance with tax and employee benefits laws.

WorldCom apparently focused its compliance review on the financial aspects. On the financial front, members of the Treasury Department performed quarterly financial tests to confirm that the Company was in compliance with the Credit Agreement's financial requirements. The Treasury Department also occasionally obtained confirmation from Mr. Sullivan that the representations regarding the Company's financial statements were correct.

On the legal front, however, members of the Treasury Department indicated that they did not regularly review the legal requirements under the Credit Agreement. Despite their lack of legal training, they also did not request legal assistance from in-house or outside counsel at any time prior to April or May 2002. Consequently, it does not appear that the legal requirements contained in the Credit Agreement were reviewed by anyone until the time of the drawdown.

The Treasury Department's failure to consider whether the Company's loans to Mr. Ebbers affected the legal requirements of the Credit Agreement is symptomatic of this omission. When asked by the Examiner how WorldCom evaluated the loans to Mr. Ebbers under the Credit Agreement, the Treasurer stated that prior to the time of the drawdown she never considered whether Mr. Ebbers' loans breached the Credit Agreement's prohibition against material transactions with affiliates, because "no one ever said it was a breach."

Meanwhile, despite awareness that the Credit Agreement required the Company to certify compliance with various legal requirements, the Company's Legal Department did not make any effort to assist in the legal aspects of the compliance process. Instead, following a pattern exhibited with all debt-related matters, the Legal Department apparently did not assume any responsibility for monitoring the Company's compliance with the terms of the Credit Agreement. The lawyers' lack of involvement was highlighted in May 2002 when a member of the Treasury Department requested legal assistance with the Credit Agreement, and a WorldCom lawyer responded by stating that they had "never been involved in the monitoring of the representations, warranties and covenants for compliance purposes, that has always been done by Treasury."

b. Inquiries from Lenders

On April 29, 2002, the lead administrative agent bank sent a letter to the Company submitting questions and comments from several of WorldCom's Lenders. Of particular interest to the Lenders was detailed information about the Company's financial position and the then pending SEC investigation of WorldCom. On May 3, 2002, the lead administrative agent bank wrote to WorldCom again, this time requesting more support for the Company's representations regarding the calculation of its ratio of total debt to total capitalization. It also requested a certificate from the Company's independent public accountants certifying that they had no reason to believe that WorldCom was not in compliance with the Credit Agreement.

These inquiries identified several areas of potential non-compliance that might have prohibited the Company from drawing down the credit facility, including: (a) the provision requiring that the Company's financial statements fairly present its financial position; and (b) the provision prohibiting material transactions with affiliates. It appears that the Company did not adequately investigate either of these issues raised.

First, the Lenders questioned whether, in light of the ongoing SEC investigation of WorldCom and the possibility that the Company's financial statements might need to be restated, the Company's financial statements fairly presented its financial position. Despite this inquiry into what proved to be an indisputable breach of the Credit Agreement, the Company's Treasurer indicated that no one was concerned about this issue because WorldCom had audited financial statements.[58]

Second, the Lenders questioned whether certain loans by WorldCom to Mr. Ebbers violated the Credit Agreement's prohibition of "material transactions" with "affiliates." Mr. Ebbers was, by definition, an "affiliate" of the Company under the Credit Agreement. Consequently, the crux of the inquiry was whether the Company's loans to Mr. Ebbers were "material transactions." Under the Credit Agreement, a materiality determination required an analysis that is to be performed in the "good faith judgment of [the Company]."

Although both the Company's in-house attorneys and its outside counsel apparently advised that the loans to Mr. Ebbers were not material transactions to the Company at the time they were made, that advice is questionable for several reasons. First, by the time the final loans were made, the aggregate amount of the loans was equal to nearly 30 percent of the cash and cash equivalents that WorldCom had on-hand. Second, the loans were made not to a random employee, but to the Chief Executive Officer of the Company and for the purpose of paying off other loans and allowing him to avoid selling an enormous amount of WorldCom stock that he had pledged as collateral for those other loans. Third, WorldCom's disclosure of the loans to Mr. Ebbers on its Form 10-Q also suggests that the Company believed the loans might be

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58 The Examiner has not identified any information that the Treasurer was aware of the accounting irregularities at the time.

material. Fourth, the Treasurer who certified that the loans were not material later acknowledged in an interview that in hindsight, such loans were so unusual that they probably were material.

4. The Company's Desperate Need for Cash

a. What WorldCom Was Saying

Although communications from the Lenders indicate that they were concerned about the possibility of a drawdown by May 2002, they may not have fully appreciated the likelihood of such an event. The Lenders were unaware of the extent of the Company's financial woes, because the Company allowed, and possibly encouraged, the Lenders to believe that the Company had more cash on hand than it actually did. For example, in an analyst conference call on May 9, Mr. Sullivan stated, "certainly there is liquidity in the company…. So we're in a very solid situation." While not an explicit representation that the Company had sufficient cash on hand, Mr. Sullivan's statement appears designed to give the impression that the Company's cash position was "solid."

This conclusion is supported by the fact that WorldCom's own Treasurer told the Examiner that, in her opinion, the Lenders thought that the Company had more cash on hand than it actually did as of May 2002.[59] She also told the Examiner that she believed the banks did not know how tightly the Company was managing its cash as of that time. This is not surprising in light of the public face WorldCom sought to put on its cash position during this period. Even after the drawdown in May 2002, Mr. Sullivan continued to represent to the WorldCom sales force, who Mr. Sullivan reasonably would have expected to relay such information to the Company's clients, that "WorldCom [was] financially sound. [WorldCom has] a solid balance sheet."

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[59] In a subsequent interview, the Treasurer said that she believed that the Lenders could have determined the Company's actual cash position based on publicly available information.

b. What WorldCom Was Doing

i. Payment Obligations

In reality, the Company's financial situation was far from "solid." As noted above, the Company had accumulated an enormous amount of debt through its debt offerings and other transactions. The financial information provided to the public and to the Company's Lenders was for the period ended March 31, 2002, and it showed that the Company had approximately $2.2 billion of available cash. However, in April and May 2002, the Company was faced with several major payment obligations (to which Mr. Sullivan alluded only briefly in the May 9 analyst conference call):

- A payment of approximately $700 million to redeem outstanding re-marketable notes and an interest payment on its outstanding bonds of approximately $700 million.
- Three payroll obligations during the month of May, which required the Company to increase its usual payroll disbursement by more than $200 million.
- A sizeable unplanned cash requirement in May as a result of the downgrading of its debt rating. The downgrade forced the Company to renegotiate its Accounts Receivable Securitization Program (the "A/R Program"), which ultimately required a payment by the Company of approximately $700 million.

Moreover, the Company also did not generate enough cash in April or May 2002 to cover its expenditures.

ii. Accruals and the Treasury Department

As the "bank" for the Company, the Treasury Department was well aware of WorldCom's cash position and of the payment obligations discussed above. It appears that the Treasury Department also had notice of some substantial additional costs that the Company might have to satisfy in the future, in the form of "accruals" that Treasury historically did not track.

For most of its operational history, WorldCom's Treasury Department generated reports showing actual cash on hand. Starting no later than the second quarter of 2001, however, Treasury inexplicably began incorporating certain accrued capital expenses into certain reports that the Treasury Department generated. Treasury apparently did not have actual knowledge of these accrued capital expenses, but added them at the direction of David Myers, the Company's Controller. Treasury employees have stated that it was highly unusual for the Treasury Department to include accrued expenses on its reports, yet no one from Treasury thought to ask why the accruals were necessary or whether they constituted future payment obligations. Consequently, as far as the Treasury Department knew, the Company could have had, as of May 2002, an additional $1.2 billion in expense payments due and owing. If, in fact, the Company had owed this additional money, its cash position in May 2002 would have been even more tenuous than it otherwise appeared.

In sum, the extent of the Company's outstanding obligations in May 2002, together with the mysterious accruals, left the Company in anything but a "solid" financial situation. The Company was strapped for cash, without any of its typical financing options available. The Company could not access the commercial paper market, particularly after its debt rating was downgraded on May 9, nor could the Company issue debt securities, given its financial situation and general market conditions. As such, WorldCom had few, if any, alternatives to borrowing money under one of its credit facilities to satisfy its outstanding obligations.[60]

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[60] WorldCom did have in place at the time of the drawdown on the $2.65 billion Credit Agreement two other credit facilities: a $3.75 billion facility that was set to expire in June 2002 and a $1.6 billion facility that was to expire in the summer of 2006. Since the $3.75 billion facility was set to expire in a couple of months, and did not have the same provision extending the term that was included in the $2.65 billion facility, this larger facility effectively was unavailable to WorldCom.

5. WorldCom's Use of the Drawdown Proceeds

a. What WorldCom Said It Would Do

WorldCom publicly stated on May 15, 2002 that it was drawing down and converting the entire $2.65 billion credit facility in order to increase the Company's bargaining power with respect to the refinancing of all of the Company's credit facilities. During the spring of 2002, the Company had been trying to convince its lenders to refinance its credit facilities. For various reasons, including those described above, the Company's lenders were resisting refinancing unless the Company provided security for the loans.

In early May 2002, WorldCom anticipated that it was unlikely to complete the refinancing before June 7, 2002, the expiration date of the Credit Agreement. As a result, on May 15, 2002, WorldCom delivered a notice of borrowing to the lead administrative agent bank for the entire $2.65 billion, and on May 17, 2002, the Company delivered a notice of conversion to a term loan.

In a conference call with some of the banks on May 15, 2002, Mr. Sullivan publicly stated that the "money [from the borrowing] won't be used for anything. The money will be sitting on the balance sheet in cash, it will be invested for a few weeks." According to its Lenders, Mr. Sullivan also explicitly stated that "the proceeds of the $2.65 billion credit facility would be placed … in a segregated account and would be repaid when WorldCom completed a $5 billion secured financing that it expected to have in place by June 30, 2002." WorldCom's statement regarding its plans to segregate the proceeds from the drawdown assured certain of its Lenders that the money would be set aside and repaid. This appears to have been false.

b. What WorldCom Intended to Do, Then Did

Despite Mr. Sullivan's public statements regarding the drawdown, it seems clear that at least as of May 4, 2002, the Company anticipated using a portion of the proceeds from the credit facility drawdown to pay off its lenders under the A/R Program. The Company's Treasurer admitted this fact in an internal communication when she stated that "[w]e pay back the A/R facility at that time and the outside world doesn't know that we need the bank draw to payback the A/R." She also reportedly told one former Board member that WorldCom would have been completely out of cash on May 31, 2002, if it had not borrowed under the Credit Agreement.

Contrary to Mr. Sullivan's public statements, when WorldCom drew down and converted the Credit Facility into a term loan, it did not segregate or invest all of the money. Instead, it used a portion of the proceeds to pay off the lenders under the A/R Program. As WorldCom's Treasurer said in an interview, WorldCom was, through the drawdown, essentially "robbing Peter to pay Paul."[61] Although the Lead Lenders purportedly knew that the Company planned to use a portion of the proceeds from the drawdown, certain of its other Lenders have filed a civil suit against the Company, and a related suit against WorldCom's Treasurer, alleging that the Lenders relied on statements that the Company would not use the proceeds when they agreed to fund the borrowing.[62]

D. Conclusion

Prior to its bankruptcy, WorldCom had nearly $41 billion in total debt, due in part to the lack of any meaningful internal controls for approving and monitoring the Company's assumption of debt. By May 2002, WorldCom's cavalier approach to debt, combined with its accounting fraud and market forces, put the Company in a precarious financial position. Because WorldCom could not rely on its traditional methods of financing (commercial paper and debt issuance), it was forced to address its cash emergency by drawing down on its $2.65 billion

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61 The Treasurer subsequently informed the Examiner that upon further reflection she did not believe that this statement accurately reflected the facts during the relevant time period.

62 See, e.g. ABN AMRO v. WorldCom, Inc., et al., Complaint (July 12, 2002).

credit facility. WorldCom's desperation apparently caused it to mislead certain of its Lenders and investors regarding both its financial condition and the manner in which it would use the drawdown proceeds.

VI. THE COMPANY'S LOANS TO BERNARD EBBERS

A. Introduction

As stated in the First Interim Report, WorldCom commenced making substantial loans to, and a related guaranty to Bank of America in favor of, Mr. Ebbers in the fall of 2000. The loans and guaranty grew substantially over time, even as WorldCom's stock price and financial results declined significantly, and under circumstances where it should have been apparent to the Board of Directors that Mr. Ebbers' financial situation and ability to repay the loans were deteriorating.[63] Moreover, the Company's commitment of hundreds of millions of dollars of shareholder assets to Mr. Ebbers occurred amidst significant evidence that Mr. Ebbers' outside business interests and personal investments may have deflected his attention from the affairs of WorldCom.

The amounts of the loans and guaranty extended by WorldCom for Mr. Ebbers from September 2000 through early 2002 were as follows:[64]

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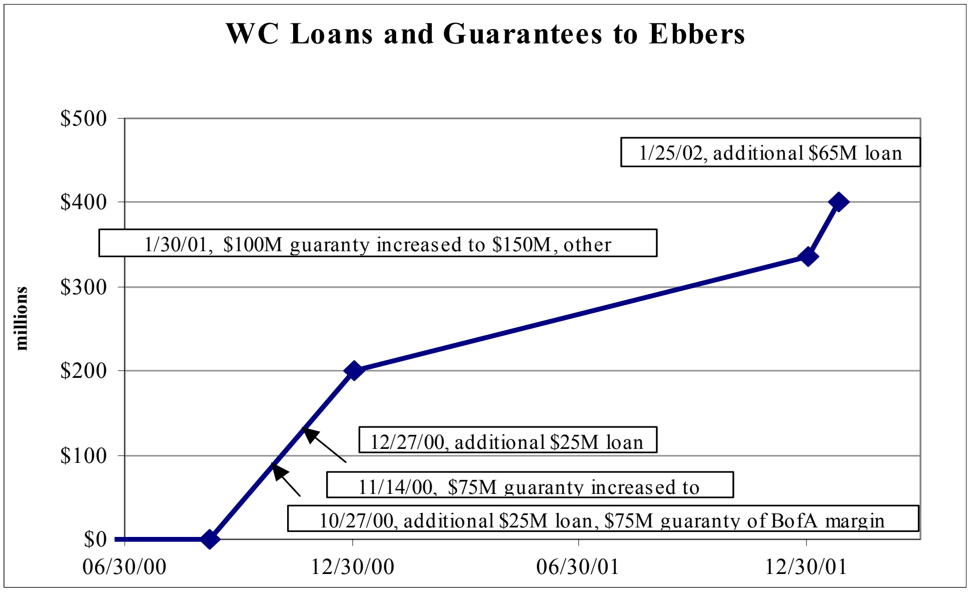
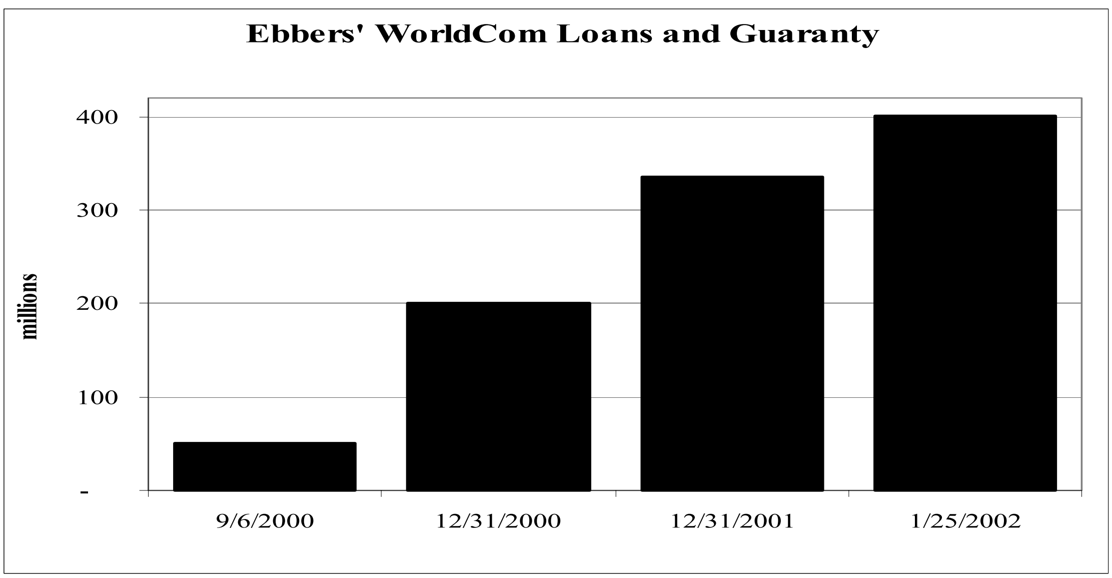
63 A chronology of the loans and guaranty is attached as Appendix 8.

64 Certain additional information regarding the terms of these loans and guaranty, as well as the favorable interest rate charged by the Company and the restructuring of Mr. Ebbers' obligations to WorldCom in the spring of 2002, is set forth in the First Interim Report and will not be repeated here. The $400.6 million aggregate loan figure reflected on these charts is exclusive of interest, and consists of approximately $198.7 million that WorldCom paid to a lender to satisfy a guaranty of Mr. Ebbers' indebtedness, approximately $36.5 million that WorldCom paid to collateralize a letter of credit that Mr. Ebbers used to support Mississippi College, and approximately $165.4 million in actual loans to Mr. Ebbers.



By period, the total amounts of the loans and guaranty were as follows:



Although it appears that the Company recently has negotiated agreements to sell some of Mr. Ebbers' assets, which eventually were pledged as security for the loans, these efforts have been only moderately successful.[65] As of the date of this Report, even after pending agreements for the sale of certain of Mr. Ebbers' assets are fully consummated, greater than 75 percent of the more than $400 million paid by WorldCom for the benefit of Mr. Ebbers will remain outstanding.

The Company's extensions of such large amounts of credit to Mr. Ebbers raise numerous questions regarding the process by which the loans and guaranty were made and the level of reasonable, informed decision-making by the Board of Directors or others at WorldCom who approved the loans and guaranty. The Examiner has undertaken to gather the relevant facts concerning the loans and the related due diligence by the Board and WorldCom Management. This Chapter contains the Examiner's observations regarding the process by which the loans and guaranty were made and related corporate governance matters.

1. Brief Background Regarding the Loans to Mr. Ebbers

Prior to addressing the loans made to Mr. Ebbers by WorldCom in detail, we believe it is important to put these somewhat extraordinary matters in context. The Company's loans to Mr. Ebbers came about as a result of Mr. Ebbers' personal investments and other activities not related to WorldCom. During the 1990s, Mr. Ebbers made huge personal investments in real estate and other ventures, including a 500,000-acre ranch in Canada, a timber farm in Mississippi and other southern states, and a shipbuilding yard in Georgia. Mr. Ebbers routinely pledged

[65] WorldCom has begun selling some of the collateral that had secured the loans. For example, the Company recently reported an agreement to sell Mr. Ebbers' 500,000 acre Canadian ranch for approximately $68.5 million. In general, however, these efforts have produced relatively modest recoveries. More than $300 million of the loan amounts remain outstanding. In addition, WorldCom recently reported that Mr. Ebbers defaulted on his first $25 million loan payment

shares of his WorldCom stock to secure the bank loans required for these and other side-businesses and personal investments. By summer 2000, the outstanding balance of Mr. Ebbers' bank debt collateralized by his WorldCom stock was approximately $440 million. One hundred percent of Mr. Ebbers' WorldCom stock – which had a market value of approximately $600 million at the time WorldCom began making loans to Mr. Ebbers in September 2000 – was pledged as collateral to secure his outstanding bank loans.

Many of the bank loans made to Mr. Ebbers included margin call provisions that required him to post additional security for his loans through the infusion of either additional stock or cash if the price of WorldCom stock fell below certain levels. If Mr. Ebbers was unable to provide additional security, he was required to sell stock he pledged to the lenders to pay down at least a portion of the loans.

As reported in the First Interim Report, there appears to be some uncertainty regarding whether Mr. Ebbers requested the loans in the first instance, or whether the Compensation Committee of the Board of Directors initiated the idea of the loans to avoid the potentially adverse market impact that may be caused by the sale of WorldCom stock by the Company's CEO. Irrespective of who initiated the idea for the loans, it is clear that the loans arose in the fall of 2000, after the Sprint merger failed and WorldCom's share price fell sharply from approximately $49 per share in mid-July 2000 to approximately $30 per share in early September 2000. This decline in the price of WorldCom stock caused bank lenders to make several substantial margin calls to Mr. Ebbers. At the time, however, Mr. Ebbers did not have additional stock to pledge to the bank lenders, nor did he have sufficient cash liquidity to meet his margin obligations. Further, Mr. Ebbers evidently was unwilling to sell any of his non-WorldCom investments to pay down his bank loans. Consequently, Mr. Ebbers was faced with the possibility that he might have to sell pledged stock and use the proceeds to pay down the loans he obtained to support his personal investments and other business interests.

During this period, WorldCom's financial performance was suffering, along with that of many other companies in the telecommunications industry. The Company's revenue growth had leveled off, its stock price was falling, and its effort to merge with Sprint had been derailed by the regulators. These events signaled that WorldCom's mega-acquisitions were over and that the Company would need to find a different way to grow or otherwise succeed. As an outgrowth of these events, WorldCom had just announced a hastily-conceived merger with Intermedia (see Chapter IV, above) and the Company was about to announce a new initiative, the Tracker stocks, to attempt to convince the market that WorldCom was undervalued. As of early September 2000, however, our investigation suggests that the candid view of many in WorldCom Management was that the telecommunications industry was out of favor with investors and that the market's negative view of the industry was unlikely to turn around any time soon. Further, within just over a month, on October 26, 2000, WorldCom would announce that it had failed to meet earnings estimates for the period ended September 30, 2000. Moreover, on November 1, 2000, the Company would announce that it was issuing new negative guidance with respect to its anticipated future financial performance.

Thus, at the very time that WorldCom began to extend substantial loans to Mr. Ebbers, the Company's overall financial situation was in great flux. The Company's financial situation never subsequently improved materially, and the price of its stock continued to fall in 2001 and early 2002, never again reaching $20 per share after April 18, 2001. None of Management's efforts during this period to enhance the value of WorldCom's stock had the desired effect. Nonetheless, the Company continued to loan greater and greater amounts to Mr. Ebbers while the value of his stock and most of his other personal holdings, which represented the only apparent means by which he could repay the Company, continued to drop precipitously.

2. Outline of Observations Regarding the Loans to Mr. Ebbers

The substantial record reviewed by the Examiner to date raises significant and troubling questions concerning the oversight by the Board of Directors and the actions by its Compensation Committee with respect to the loans and guaranty for the benefit of Mr. Ebbers. In particular, the sequence of events surrounding the loans suggests a profound lack of diligence on the part of the Compensation Committee and the Board of Directors. It also reinforces the notion that the Company's Directors were all too often a passive rubber stamp for Management and especially Mr. Ebbers.

In making these observations, we are mindful that Mr. Ebbers was the founder of WorldCom and that members of the Board apparently placed great confidence in him over the years. However, Mr. Ebbers' vast personal investments and outside business interests, primarily obtained by collateralizing his entire WorldCom stockholdings, imperiled the Company when the threat of the potential sale of some of this stock became real. Indeed, many Directors whom we interviewed indicated that the disclosures of the loans and guaranty caused them to lose confidence in Mr. Ebbers.

For the reasons discussed in greater detail below, the Examiner makes the following observations regarding the internal processes associated with the loans that WorldCom made to Mr. Ebbers:

- The Board of Directors and the Compensation Committee failed to conduct meaningful due diligence prior to issuing the loans and providing or extending the guaranty.

- The Board of Directors and the Compensation Committee failed to investigate whether creditors had prior perfected interests in Mr. Ebbers' assets before causing the Company to make the loans and guaranty.

- The Board of Directors and the Compensation Committee, as well as in-house counsel, failed to document properly the loans and guaranty before funds were advanced to Mr. Ebbers.

- The Board of Directors and the Compensation Committee failed to monitor Mr. Ebbers' financial situation and his ability to repay the loans and the guaranty, even though the value of his WorldCom stock was declining and even though all of his stock previously had been pledged as collateral to various bank lenders.

- The Board of Directors and the Compensation Committee failed to establish any procedures to ensure that Mr. Ebbers used the loan proceeds only to satisfy his margin calls until the fall of 2001, by which time Mr. Ebbers had used significant amounts of the loan proceeds to prop up his personal investments.

- The Board of Directors and the Compensation Committee, as well as in-house counsel, failed to perfect any security interests in assets held by Mr. Ebbers until his debt to WorldCom grew to approximately $400 million.

Based upon all the information currently made available to the Examiner, it seems clear that by late 2000, and certainly by sometime in 2001, the Board and the Compensation Committee should have had considerable doubt both as to Mr. Ebbers' ability to repay the loans and as to Mr. Ebbers' undivided attention to the affairs of WorldCom, especially given his personal financial situation and his repeated need to turn to the Company for financial assistance. The fact that the Board and its Compensation Committee failed until April 2002 to address what seems to have been an obvious and growing problem reflects significant and costly failures.

B. Mr. Ebbers' Financial Situation

In assessing matters related to the loans made to Mr. Ebbers by WorldCom, it is useful to provide an estimate of Mr. Ebbers' indebtedness, and his overall net worth in light of that indebtedness, as of September 2000 when the loans began. Due to an absence of complete records, some of the data provided below are informed estimates.

As of early September 2000, Mr. Ebbers owned approximately 19.4 million shares of WorldCom stock. The market value of his WorldCom shares was approximately $611 million on September 6, 2000. In addition to his WorldCom stock, Mr. Ebbers' other major holdings as of September 1, 2000 were the Douglas Lake Ranch (the "Canadian ranch"), Joshua Holdings (the "timber farm"), and a shipyard and yacht sales business in Georgia.

Over the years, Mr. Ebbers had incurred extremely large debts in order to invest in his various personal business ventures. As of September 6, 2000, it appears that Mr. Ebbers had outstanding debts and guaranties of at least the following:

Bank of America	$310 million
Citibank	52 million
PaineWebber, Inc.	65 million
Morgan Keegan	13 million
Total:	**$440 million**[66]

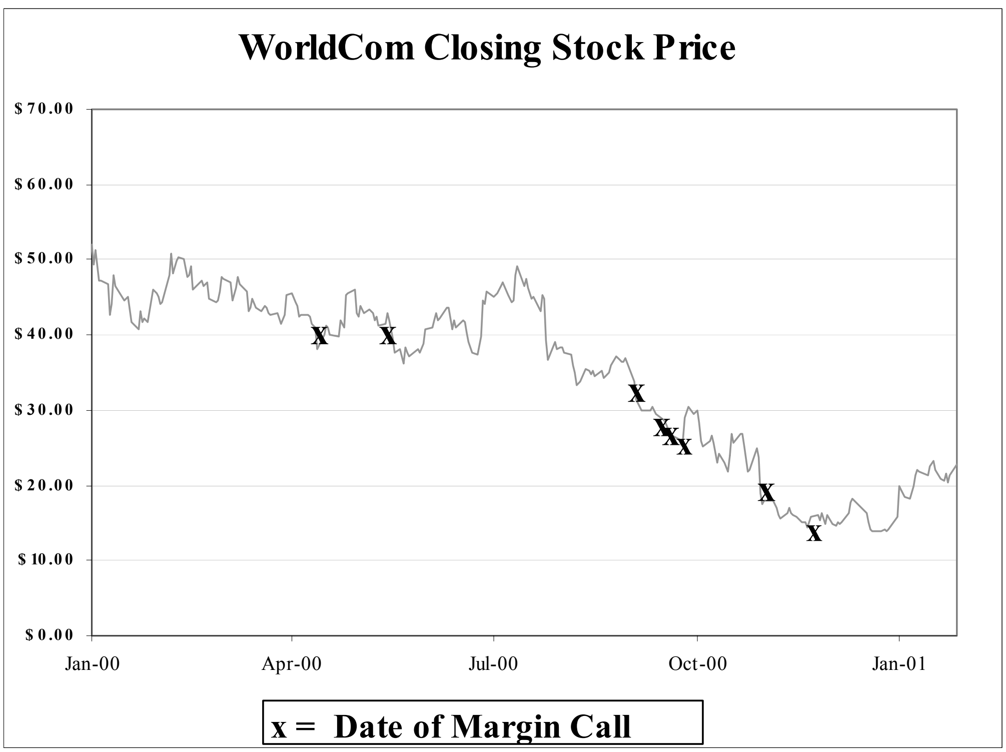
Despite an extensive review of available data, we are not yet able to state with precision Mr. Ebbers' net worth as of early September 2000, when the WorldCom loans began. However, on a preliminary basis, the Compensation Committee could have concluded that Mr. Ebbers had a net worth of at least $200-400 million, although that net worth decreased dramatically as WorldCom's stock price fell substantially during the remainder of 2000.

Irrespective of any continuing uncertainty regarding Mr. Ebbers' financial situation in September 2000, two things are clear: (i) Mr. Ebbers had vast amounts of assets; and (ii) Mr. Ebbers had massive debts. It is also clear that Mr. Ebbers' bank loans were so great that banks refused to lend him additional sums and that his lender banks demanded additional

[66] These are estimates based primarily on Bank of America records. We are seeking other bank records to confirm these numbers.

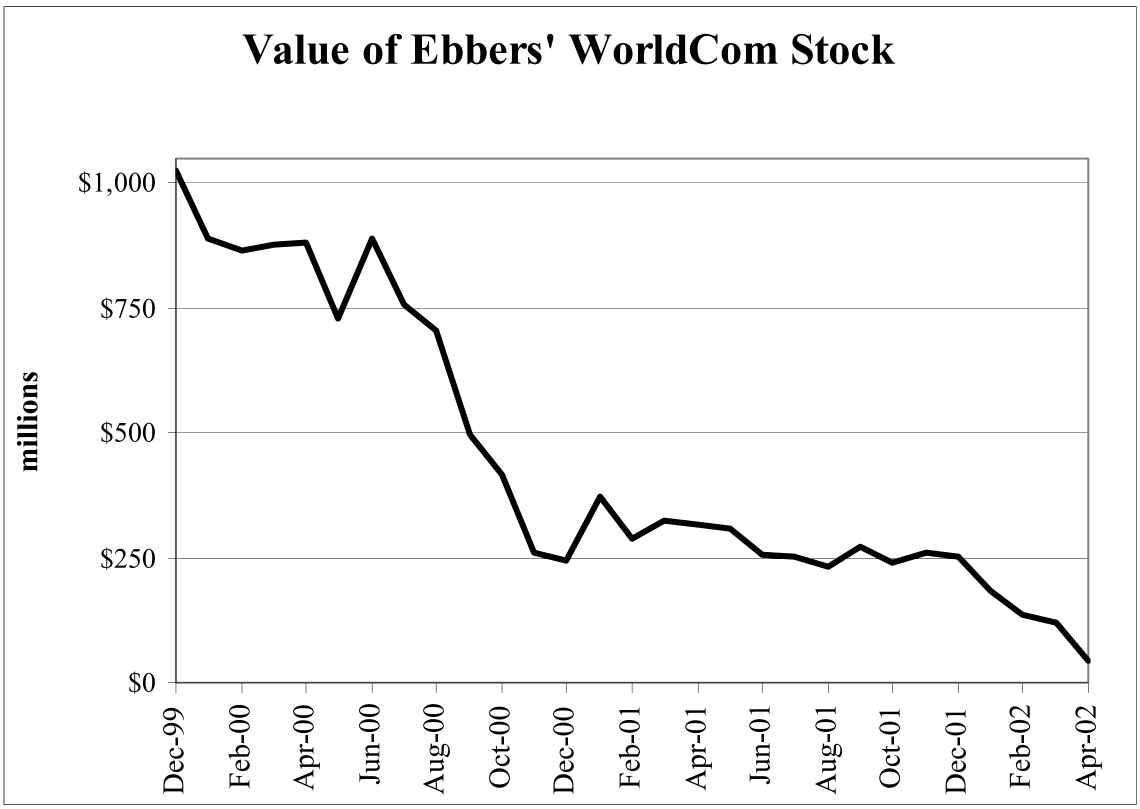
security for their loans to Mr. Ebbers because of the large decrease in the value of his pledged stock.

As depicted on the following chart, WorldCom's stock dropped from approximately $52 per share early in 2000 to $31.50 per share on September 6, 2000. The stock price continued to fall throughout the remainder of 2000 and the declines in the value of Mr. Ebbers' WorldCom stock prompted several margin calls on his personal bank loans.[67]



[67] This chart reflects margin calls made by Bank of America. The Examiner does not have data regarding margin calls by other lenders during this period.

In all, the value of Mr. Ebbers' stockholdings dropped from more than $1 billion to approximately $600 million as of early September 2000. The value of his WorldCom holdings continued its steep decline throughout the lending period, by the end of which, as noted above, WorldCom had extended credit to Mr. Ebbers in the aggregate amount of more than $400 million.



C. Compensation Committee Due Diligence Regarding the Loans and Guaranty

The Examiner has substantial questions regarding the absence of due diligence and reasonable oversight by the Compensation Committee with respect to the loans by WorldCom to Mr. Ebbers. During the relevant period, WorldCom's Compensation Committee was composed of Messrs. Kellett (Chairman), Bobbitt, Macklin and Tucker (ex-officio).[68] The Committee's consideration of issues related to the loans is summarized as follows:

1. September 6, 2000: The Compensation Committee Approves a $50 Million Loan

Facing unidentified margin calls on his pledged stock in early September 2000, but not desiring to sell his WorldCom stock or other properties, it appears that Mr. Ebbers approached Mr. Kellett on September 6, 2000 to request a loan.[69] During a "five-minute meeting" that occurred between the two on this day, Mr. Ebbers professed to need only a short-term loan of $50 million to address his margin calls. Mr. Kellett agreed to present Mr. Ebbers' request to the entire Compensation Committee for consideration. Mr. Ebbers did not provide Mr. Kellett or the Compensation Committee with any written documentation of his margin calls or his inability to meet them.

Later that day, the Compensation Committee gathered for its previously scheduled committee meeting. At that meeting, Mr. Kellett presented Mr. Ebbers' request for a loan of $50 million and, after a short discussion, the Committee agreed to grant it.[70] The Committee performed no due diligence. In fact, it appears that there was no analysis or discussion whatsoever by the members of the Compensation Committee with respect to Mr. Ebbers' ability to repay the loan, other than their observation that the value of Mr. Ebbers' WorldCom stock was

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68 Over time, the Committee effectively came to be Messrs. Kellett and Bobbitt, as Messrs. Macklin and Tucker became increasingly inactive. As noted, Mr. Tucker was an ex-officio member during most of the lending period.

69 As noted above, there is some uncertainty in the record regarding who initiated the prospect of a loan by WorldCom to Mr. Ebbers on September 6, 2000. Although the matter is not free from doubt, the weight of the evidence appears to suggest that Mr. Ebbers initially requested that the Compensation Committee authorize a $50 million loan on that date.

70 At this same time, the Compensation Committee also awarded Mr. Ebbers a $10 million cash retention bonus. The retention bonus is discussed in more detail in Chapter VIII, below.

substantial. Instead, the Committee focused solely on the negative impact that a forced sale of Mr. Ebbers' stock potentially would have on shareholder value, without exploring, or asking Mr. Ebbers to explore, other options to address his margin calls, such as a sale of other, non-stock assets by Mr. Ebbers or a repurchase of Mr. Ebbers' shares by the Company.

It appears that the Chairman of the Compensation Committee and certain other members of the Committee believed that they were agreeing to extend the initial $50 million loan to Mr. Ebbers as a temporary or "stopgap" solution to his financial difficulties. These Directors apparently assumed that the $50 million loan would be repaid quickly, based, at least in part, on their understanding that Mr. Ebbers had repaid within 30 days a multi-million dollar loan that he obtained from the Company to cover a margin call several years earlier.[71]

Had the Committee gathered information regarding Mr. Ebbers' finances at the time of the first $50 million loan, it would have discovered that Mr. Ebbers had debts to other lenders totaling more than $440 million on September 6, 2000. The Committee also would have discovered that the value of his WorldCom stock securing those loans was more than $600 million. Accordingly, when WorldCom made the first $50 million loan to Mr. Ebbers, it appears that a "cushion" existed to cover his WorldCom and other debt. Although the Examiner does not condone the lack of due diligence or meaningful inquiry by the Compensation Committee prior to its September 6, 2000 decision, if due diligence had been performed, it appears that the Committee may reasonably have concluded that the $50 million loan did not present a great risk to the Company.

A regular quarterly meeting of the WorldCom Board was held the following day, on September 7, 2000. Over the years, it was a regular practice for there to be Committee Reports

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[71] In fact, Mr. Ebbers took four to five months to repay a $14 million loan made to him by the Company or its predecessor in 1994. See Appendix 8.

at Board meetings. These reports typically included reports by both the Compensation Committee and the Audit Committee. The Agenda for the September 7, 2000 Board meeting included Committee Reports, but it appears that only the Audit Committee reported on that date.[72] Accordingly, the Compensation Committee did not inform the full Board that Mr. Ebbers had been granted a $50 million loan to meet a margin call in September 2000. In fact, as discussed below, the Compensation Committee did not discuss the loans to Mr. Ebbers with the full Board until November 16, 2000, after the loans and guaranty had grown to $175 million and following disclosure regarding the loans and guaranty to the Company's shareholders in a filing on Form 10-Q.[73]

2. Late September 2000: The Compensation Committee Refuses to Extend Additional Loans to Mr. Ebbers

Mr. Ebbers exhausted his first $50 million loan from WorldCom quickly. Faced with yet another margin call, Mr. Ebbers approached Mr. Kellett regarding an additional loan from the Company on or about September 26, 2000. Mr. Kellett refused, noting that the Committee had just granted him a $50 million loan. In response to this refusal, and in direct contradiction to his frequent admonitions against WorldCom employees selling stock, Mr. Ebbers decided to engage in a forward sale of 3 million shares of his WorldCom stock, which produced approximately $70

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72 We do not know whether the lack of a Compensation Committee report on September 7, 2000 was part of an effort by Mr. Ebbers, who controlled the agenda, to keep the loan a secret, at least at that time. Contemporaneous notes prepared by the in-house lawyer who attended Compensation Committee meetings indicate that Messrs. Bobbitt and Kellett instructed that the loans to Mr. Ebbers be kept secret and that discussion of them could result in termination.

73 Mr. Kellett justified the lack of Board participation in the initial loans and guaranty process by stating that the Compensation Committee did not believe that the Board's approval was necessary for it to grant loans to Mr. Ebbers or to extend a guaranty to Bank of America on his behalf. To that end, Mr. Kellett said that he specifically asked the in-house lawyer who prepared minutes of most Compensation Committee meetings in the fall of 2000 whether Board approval was necessary for the loans, and that the lawyer determined it was not. The in-house lawyer denied providing such advice.

million in proceeds. Issues and observations related to this forward sale are discussed in Chapter VII, below.

After the market received the news of Mr. Ebbers' forward sale, WorldCom's stock price dropped by approximately $2.25 per share. It is not clear whether, or to what extent, the disclosure of Mr. Ebbers' forward sale – as opposed to other factors that adversely impacted telecommunications stocks generally on that date and during the relevant time frame – caused the price of WorldCom stock to decline. Nonetheless, members of the Compensation Committee profess that this dip in the price of WorldCom stock reinforced their fears regarding the consequences of additional sales of WorldCom shares by Mr. Ebbers.

3. October and November 2000: WorldCom Extends to Mr. Ebbers a $25 Million Loan and Grants a $100 Million Guaranty to Bank of America

As the value of the WorldCom stock held by Mr. Ebbers continued to decline, Bank of America, which was a major lender to Mr. Ebbers, resisted making further loans to Mr. Ebbers and refused to take Mr. Ebbers' non-stock assets as collateral for his debts. To prevent potential declines in WorldCom's stock price as a result of Mr. Ebbers' sales to address impending margin calls, the Compensation Committee approved an additional loan to Mr. Ebbers in the amount of $25 million and extended to Bank of America a guaranty to induce it to forbear from making additional margin calls.

A review of the facts and circumstances surrounding this additional loan and initial guaranty is instructive.

a. Bank of America Declined to Take Mr. Ebbers' Non-Stock Assets as Collateral, but Accepted a Guaranty to Induce It to Forbear from Certain Future Margin Calls

In October 2000, Mr. Bobbitt contacted a senior official at Bank of America, one of his long-time acquaintances, to arrange a meeting between representatives of the Compensation

Committee and Bank of America representatives to discuss Mr. Ebbers' debt issues. At a meeting on October 20, 2000, Compensation Committee members Bobbitt and Tucker, along with Mr. Ebbers, tried to convince Bank of America to take a security interest in Mr. Ebbers' non-stock assets, so that WorldCom did not have to make additional loans to cover his debts to Bank of America.

Bank of America and the Compensation Committee agreed at the October 20, 2000 meeting to consider a plan under which WorldCom would guarantee a certain portion of Mr. Ebbers' debt to Bank of America, while Bank of America reviewed Mr. Ebbers' non-stock assets to determine whether they were acceptable collateral for his debt. If these other assets were sufficient, Bank of America would take a security interest in them without a guaranty from WorldCom and refrain from future margin calls.

At this time, Mr. Bobbitt apparently assumed a coordinating role with respect to matters related to a review of Mr. Ebbers' stock and non-stock assets. It appears that Mr. Bobbitt, who was also Chairman of the Audit Committee of the Board of Directors, assumed this role because he was a certified public accountant and because others believed that he possessed a strong financial background. After the meeting with Bank of America, Mr. Bobbitt apparently began to gather limited information regarding Mr. Ebbers' assets. However, we have not been provided with any information that Mr. Bobbitt might have collected at this time, other than a series of three draft proposals that included summary financial information, dated October 22 and 23, 2000. These proposals were to be used by the Compensation Committee to convince Bank of America to extend further credit to Mr. Ebbers and forbear from additional margin calls based upon valuations of Mr. Ebbers' non-WorldCom assets. Although these draft proposals referred to specific valuations of certain of Mr. Ebbers' non-stock assets, it appears that Mr. Ebbers or

Mark Lewis, a personal representative for Mr. Ebbers, may have provided the figures to the Compensation Committee without any backup or supporting documentation. The Examiner has not identified any documentation indicating that the Committee took steps to verify or confirm any information reflected in the draft proposals.

Ultimately, on October 23, 2000, Mr. Bobbitt proposed that Bank of America take a security interest in Mr. Ebbers' timber farm and that WorldCom would make available to Bank of America a guaranty until Bank of America's interest in the timber farm was secured. Thereafter, Bank of America undertook an analysis of the timber farm. By November 9, 2000, Bank of America had completed its evaluation, determined that it would not take an interest in the timber farm because the timber farm was fully-leveraged, and advised Mr. Ebbers and the representatives of the Compensation Committee in writing of its decision. An analysis prepared by Bank of America indicated that "in liquidation, proceeds [of the timber farm] will barely be able to cover existing debt" because Mr. Ebbers bought the property at the peak of the market and the market subsequently softened. Thus, Bank of America took no additional collateral from Mr. Ebbers, but it did accept a guaranty from WorldCom in exchange for its agreement to forbear from making certain margin calls to Mr. Ebbers.

The draft proposals indicate that the Compensation Committee initially considered a guaranty of $50 million. However, when the Committee first approved the guaranty on October 27, 2000, it was for $75 million. Impending margin calls apparently required the Compensation Committee to increase this guaranty to $100 million on November 13, 2000.

b. The Compensation Committee Extended an Additional $25 Million Loan to Mr. Ebbers and Mr. Ebbers Agreed to Give WorldCom a Second Interest in His WorldCom Stock

On October 27, 2000, the Compensation Committee also approved an additional $25 million loan to Mr. Ebbers, stating in the Committee minutes that it was in the best interests of the shareholders to avoid the sale of Mr. Ebbers' WorldCom stock. Soon after this additional $25 million loan was approved, on November 1, 2000, a letter from Mr. Kellett to Mr. Ebbers confirmed WorldCom's initial $75 million guaranty to Bank of America on behalf of Mr. Ebbers, as well as Mr. Ebbers' agreement to grant WorldCom a security interest in the shares of WorldCom stock he owned. That letter acknowledged, however, that the Company's security interest was subordinate to those of Mr. Ebbers' other lenders, who already had secured his stock as collateral for credit they had extended to him. Notwithstanding this subordinated interest, it appears that the Committee continued to hope and believe that Mr. Ebbers' stock would provide WorldCom with enough security for the loans and guaranty. The reasonableness of this hope and belief is suspect, particularly when viewed as the professed justification for the commitment of such large amounts of shareholder assets.

By late October 2000, the value of Mr. Ebbers' WorldCom stock had deteriorated so much that it was approximately equal to the value of his outstanding bank debt. Thus, it appears that the $170+ million cushion that existed in September 2000 when WorldCom made its first loan to Mr. Ebbers had disappeared in less than two months.

c. The Compensation Committee Refused to Heed Bank of America's Warnings About Mr. Ebbers' Financial Situation

Despite being copied on the November 9, 2000 letter from Bank of America to Mr. Ebbers concerning the bank's unwillingness to accept the timber farm as collateral, Messrs. Bobbitt and Kellett informed the Examiner that they were unaware Bank of America had discovered significant problems regarding Mr. Ebbers' other assets. Mr. Ebbers' primary contact at Bank of America informed the Examiner that she specifically remembers sending the letters to Messrs. Bobbitt and Kellett and that she made clear to them in related conversations that Bank of America took issue with the value of the timber farm.

In addition, although Mr. Ebbers authorized Bank of America to give the Compensation Committee "information concerning the relationship between the Bank and Mr. Ebbers and the Ebbers' Entities," the only documents apparently exchanged between Messrs. Bobbitt and Kellett and Bank of America were documents related to Mr. Ebbers' Bank of America loan draw-downs and correspondence regarding the restructuring of Mr. Ebbers' Bank of America debt and WorldCom's guaranty to Bank of America. The Bank of America representative involved in these matters informed us that she would have shared the vast majority of her internal documents with the Compensation Committee had its representatives requested the materials. Those documents would have showed clearly that Bank of America thought little of Mr. Ebbers' non-WorldCom assets and, in fact, lent primarily based on the value of Mr. Ebbers' WorldCom stock. Further, contemporaneous documents show that some individuals at Bank of America thought Mr. Ebbers was insolvent during this period. The Bank of America representative recalled numerous frank discussions with members of the Compensation Committee about Mr. Ebbers' highly-leveraged and problematic assets, lack of liquidity, and shrinking net worth beginning in the fall of 2000. At a minimum, those conversations, along with Bank of America's refusal to accept Mr. Ebbers' non-stock assets as collateral, should have raised a red flag to the Compensation Committee regarding Mr. Ebbers' deteriorating financial situation.

Mr. Kellett informed the Examiner that the Committee did not take advantage of its ability to gather information from Bank of America because it continued to have more faith in the value of WorldCom stock than in Mr. Ebbers' other assets. The Examiner finds this rationale unpersuasive. By mid-November 2000, when the guaranty was increased to $100 million, the value of Mr. Ebbers' WorldCom stock, all of which was pledged to other lenders, had decreased from approximately $611 million in September 2000 to approximately $297 million. Mr. Ebbers' outstanding bank debt, which had been reduced slightly through certain margin call payments, was then approximately $376 million. Thus, less than three months into the 20-month loan period, Mr. Ebbers' stock collateral for his WorldCom debt was already worth approximately $80 million less than the value of his outstanding bank debt.

The Examiner has significant concerns about the actions of the Compensation Committee during this time frame. The record strongly suggests that it should have been apparent to the Committee that Mr. Ebbers' WorldCom stock was fully pledged to other lenders and that there was no "cushion" in the value of Mr. Ebbers' stock. Further, any "hope" or "belief" in the recovery of WorldCom's stock price was extremely questionable under the circumstances, and in any event, seems a paltry justification for the additional loans and guaranty. The Compensation Committee's apparent belief that the $175 million in loans and a related guaranty extended to Mr. Ebbers by November 16, 2000 were in WorldCom's best interest seems unjustified and without rational basis.

4. Late December 2000: WorldCom Extends Another $25 Million Loan to Mr. Ebbers

Through December 2000, WorldCom's stock price continued to deteriorate. What was a bad situation in November 2000 became even worse by the end of the year when the stock price hovered near $14 per share. Mr. Ebbers received more margin calls. Faced yet again with the prospect of Mr. Ebbers selling additional stock, the Compensation Committee determined to lend Mr. Ebbers an additional $25 million on December 27, 2000.[74]

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[74] In the case of this loan, it appears that Mr. Ebbers knew that he was about to exhaust the $25 million loan approved by the Compensation Committee on October 27, 2000. The last disbursement on that loan was made on December 29, 2000, the same day that Mr. Ebbers began to draw on the loan approved on December 27. The full Board of Directors later ratified the December 27 loan on March 1, 2001. There is no evidence that any Director voiced an objection or concern about this or any previous

As before, the Committee extended these additional funds to Mr. Ebbers without doing any real due diligence regarding his financial situation and without regard for the warnings by Bank of America regarding Mr. Ebbers' impaired assets. If the Committee members had analyzed Mr. Ebbers' stock holdings at the time, they would have realized that the value of Mr. Ebbers' WorldCom stock was only approximately 64 percent of his bank debt as of the end of December 2000. While Mr. Ebbers' bank debt continued to hold steady at near $400 million because of WorldCom's cash infusions, Mr. Ebbers' stock was worth less than $250 million. Thus, in just four months, the value of Mr. Ebbers' WorldCom stock, which appeared to represent his only significant means to repay not only the lender banks, but also WorldCom, had fallen by over $350 million.

5. January 30, 2001: The Committee Approves a Replacement Guaranty for $150 Million Plus "Certain Additional Payments"

On January 31, 2001, in order to accommodate the restructuring of Mr. Ebbers' debt to Bank of America, the Compensation Committee determined it was in the best interests of WorldCom shareholders to increase the guaranty to Bank of America on Mr. Ebbers' behalf to $150 million, plus "certain additional payments." Under this arrangement, Bank of America amended its loan agreements with Mr. Ebbers to account for WorldCom's sharply deteriorating stock price and to provide, for the first time, a structure for regular payments on Mr. Ebbers' various obligations to the bank. As a condition to those amendments, WorldCom agreed to provide even further coverage for Mr. Ebbers' debts. Specifically, WorldCom agreed to extend its guaranty on behalf of Mr. Ebbers to $150 million, plus "certain additional payments," as

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loan to or guaranty on behalf of Mr. Ebbers. By March 2001, WorldCom had agreed to loan Mr. Ebbers $100 million and had issued a guaranty of over $200 million.

required by Bank of America. In doing so, WorldCom effectively replaced Bank of America as Mr. Ebbers' primary lender.

The "additional payments" made by WorldCom under this expanded guaranty arrangement eventually totaled $85.2 million, which increased Mr. Ebbers' debt to the Company under the guaranty to $235.2 million.[75] At this time, Mr. Ebbers' outstanding bank debt continued to exceed substantially the value of his stock.

6. January 25, 2002: The Committee Extends An Additional $65 Million Loan to Mr. Ebbers

In January 2002, Mr. Ebbers needed even more funds and he asked the Compensation Committee for another loan. Apparently, for the first time, Mr. Ebbers offered his interest in the timber farm as collateral for a loan from the Company, and while the Committee agreed to discuss his request, Mr. Ebbers was told that this would be the final loan from WorldCom.

The Compensation Committee approved this request and the Company made an additional loan to Mr. Ebbers in the amount of $65 million.[76] When asked, the Directors on the Compensation Committee had little recollection as to why they approved this loan, but it has been suggested that the loan may have been granted effectively to "buy" Mr. Ebbers' collateral. In other words, in light of WorldCom's continued stock price deterioration, this final loan may have been granted to induce Mr. Ebbers to provide collateral for the previous loans and guaranty.

Soon thereafter, in February 2002, the Compensation Committee began to gather information regarding Mr. Ebbers' non-stock assets, perhaps because the Committee finally

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[75] The guaranty again was modified slightly in January 2002 to accommodate further restructuring of Mr. Ebbers' debts to Bank of America. Based upon our interviews with Directors, it appears that the full Board was unaware of the potential magnitude of this guaranty.

[76] The Board of Directors' meeting minutes do not reflect the approval or ratification of this loan. Further, although the authorized loan amount was $65 million, it appears that Mr. Ebbers actually received a loan of $65,374,822.

realized that the value of Mr. Ebbers' WorldCom stock provided inadequate security for his substantial debts. At that time, the value of Mr. Ebbers' stock represented only approximately 50 percent of the amounts loaned to him by WorldCom. Thus, although the Company later perfected its security interest in Mr. Ebbers' stock holdings, WorldCom's extensions of credit to Mr. Ebbers remained largely unsecured by realizable collateral.

7. The Compensation Committee Failed to Perform Adequate Due Diligence Regarding Mr. Ebbers' Ability to Repay His Debts to WorldCom

The Examiner is troubled that the Compensation Committee apparently did not attempt to ascertain the true nature of Mr. Ebbers' non-stock assets until late February 2002. At that time, perhaps as "compensation" for the $65 million loan made to him by the Committee on January 25, 2002, the Committee began to collect additional financial information from Mr. Ebbers through his personal representative, Mr. Lewis. This information was first transmitted to members of the Compensation Committee on February 28, 2002.[77] On that date, Mr. Ebbers owed WorldCom over $377 million and his WorldCom stock – most of which still was pledged primarily to other lenders – was worth only approximately $135 million.[78]

In defense of the due diligence performed by the Compensation Committee with respect to the loans and guaranty, both Mr. Kellett and Mr. Bobbitt provided two responses. First, they noted that, in response to a shareholder derivative lawsuit filed in 2001, which included claims regarding the loans, counsel hired to defend the lawsuit advised that the claims were not strong.

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[77] It appears that the request to obtain such data may not have come directly from the Compensation Committee itself, but from outside counsel for WorldCom, who, by February 2002, was involved in WorldCom's efforts to obtain additional collateral for the loans and guaranty.

[78] Shortly thereafter, in early March 2002, the Committee received additional materials, including a "financial statement" prepared for Mr. Ebbers, which purported to describe his financial condition as of December 31, 2001. While Mr. Ebbers apparently had commissioned financial statements for prior years, none were found among WorldCom's files.

However, even if the lawsuit was baseless, the Examiner does not believe that this justifies the failure of the Committee to request or obtain appropriate security for the commitment of hundreds of millions of dollars of shareholder assets to address Mr. Ebbers' personal debt problems.

Second, Mr. Bobbitt claimed that he repeatedly demanded that Mr. Ebbers provide additional financial information to the Compensation Committee beginning in mid to late 2001, but that Mr. Ebbers continually resisted. This fact further diminishes the reasonableness of the actions by the Compensation Committee. The Examiner finds the decision of the Compensation Committee to continue to extend credit to Mr. Ebbers despite evidence of his refusal to cooperate with the Company to be inherently problematic.

Beyond the observations outlined above, it is significant that by the time the Compensation Committee obtained financial information regarding Mr. Ebbers' non-stock assets in late February and March 2002, the information was partially in draft form, unaudited, and, under the circumstances, unreliable. As a threshold matter, the "financial statement" supplied for Mr. Ebbers, which was dated as of December 31, 2001, indicates on its face that it was merely a compilation "limited to presenting in the form of financial statements, information that is the representation of the individual whose financial statements are presented." Mr. Ebbers' accountants expressly stated that they did not audit this compilation or review the accompanying statements of financial condition or supplementary schedules, and that the "financial statement" deviated from GAAP.[79]

[79] In addition, others who reviewed these materials refused to rely upon the financial information Mr. Ebbers provided to the Compensation Committee in 2002. For example, internal e-mails reflect that in-house lawyers were concerned about the accuracy of the valuations supplied by Mr. Ebbers within the context of an SEC inquiry regarding WorldCom in early 2002. Even Mr. Ebbers' own lawyer refused to verify the accuracy of Mr. Ebbers' financial information to outside counsel for the Company in March 2002.

In addition, when the Compensation Committee received Mr. Ebbers' "financial statement" for the period ended December 31, 2001, it was already substantially outdated. For example, WorldCom's stock price was $14.08 as of December 31, 2001, but it had dropped to approximately $7 on March 15, 2002. With respect to Mr. Ebbers' non-stock assets, valuations for the same properties at the same general times are significantly different and many appear erroneous. The Compensation Committee never sought to obtain any independent evaluations of these assets or supporting documentation concerning the valuations reflected on Mr. Ebbers' "financial statement."

Further, even limited investigation by the Compensation Committee would have raised significant questions regarding the asset valuations supplied on behalf of Mr. Ebbers. For example, if the Compensation Committee had probed regarding the valuation ascribed to Mr. Ebbers' Canadian ranch, it would have determined that the information provided to the Compensation Committee was nothing more than a "guesstimate" by the ranch manager of the value of the ranch's primary assets. In fact, the ranch had not been officially valued since 1990. Moreover, this "guesstimate" was more than 45 percent higher than Mr. Ebbers' purchase price for the ranch in mid-1998. The Compensation Committee apparently never considered this discrepancy.

The Committee's reliance on the value supplied to it with respect to Mr. Ebbers' interest in the timber farm is similarly problematic. The "financial statement" provided to the Compensation Committee in March 2002 reflects that Mr. Ebbers had an equity interest in the timber farm equal to $206 million, as determined by the timber farm's management in reliance upon a draft third party appraisal of the timber farm's "market value" as of March 31, 2001. Another document, which apparently was provided to the Compensation Committee in late

February 2002, reflects that Mr. Ebbers' equity in the timber farm was worth $286 million – $80 million more than the value reflected on his "financial statement." It appears that Mr. Bobbitt used the higher $286 million figure in evaluating Mr. Ebbers' finances and never attempted to reconcile the $80 million discrepancy.

If the Compensation Committee had examined these data, it would have determined that the book value of Mr. Ebbers' interest in the timber farm was less than $31 million as of December 31, 2001, and that there was no documentary evidence to support a valuation figure in the range supplied on behalf of Mr. Ebbers. The Committee also would have learned that, eight months earlier, Mr. Ebbers was informed that other lenders had questioned the draft appraisal that formed the basis for his representations to the Committee. Specifically, on or about June 28, 2001, Mr. Ebbers executed a short amendment to a loan agreement related to the timber farm, which stated that its lenders refused to rely upon the draft appraisal, and that the lenders did "not agree that such values or the methodology, analysis, discount rate or assumptions made or contained in [the draft appraisal] are correct, true or accurate." Further, as discussed above, the Examiner's investigation reveals that both Mr. Ebbers and the Compensation Committee learned in November 2000 that Bank of America refused to take the timber farm as collateral for Mr. Ebbers' debts. Indeed, the problems identified by Bank of America in late 2000 should have raised significant questions in the minds of Committee members regarding whether Mr. Ebbers' interest in the timber farm had any value at all. The Committee's apparent reliance on the $286 million figure suggested by one of the documents provided on behalf of Mr. Ebbers is highly-suspect under these circumstances.

Moreover, if the Compensation Committee had performed adequate due diligence, it also would have learned that Mr. Ebbers already had encumbered 65 percent of his interest in the timber farm under a 1999 Pledge Agreement with another lender. Thus, only 35 percent of Mr. Ebbers' equity interest in the timber farm was available to WorldCom as collateral.

Finally, the "financial statement" supplied on behalf of Mr. Ebbers reflected that his interest in the shipyard and yacht sales business was worth $41 million based on the "book value of the shipyard's assets." The Examiner believes this valuation is questionable given that our investigation reveals that the shipyard lost in excess of $17 million on $30 million of sales from September 2000 through December 2001, and that Mr. Ebbers was required to infuse $18 million of cash to keep the shipyard operating during that same period. Further, this "book value" figure appears to include the value associated with constructing partially-completed boats for which there were no identifiable customers, as well as loss reserves related to Mr. Ebbers' acquisition of the shipyard. The Examiner believes the Compensation Committee should have determined that this $41 million figure substantially overstated the value of Mr. Ebbers' interest in the shipyard in early 2002. In 2003, the shipyard and yacht sales business was sold for less than $10 million.

In sum, a reasonable review of Mr. Ebbers' "financial statement" as of December 31, 2001, and related data available to the Compensation Committee during the relevant period, reflects that the value of the collateral Mr. Ebbers ultimately provided to WorldCom was grossly inadequate to cover his debts to the Company. By failing to evaluate properly Mr. Ebbers' ability to repay his debts, the Committee and the Board breached its duties to the Company and its shareholders.

8. WorldCom Failed to Monitor Mr. Ebbers' Use of the Loan Proceeds

WorldCom also failed to establish reasonable procedures for monitoring the loans and guaranty. Indeed, for most of the lending period, it appears that neither the Compensation Committee nor anyone else at WorldCom established any procedures for: (1) distributing the loan proceeds to Mr. Ebbers; (2) maintaining adequate records of the amounts dispersed to, or paid for the benefit of, Mr. Ebbers; or (3) monitoring Mr. Ebbers' use of the borrowed funds. Instead, over time, an informal procedure evolved by which Mr. Ebbers would request funds when he desired them and WorldCom would disperse the funds, virtually immediately. Several individuals apparently attempted to keep records of the amounts loaned to Mr. Ebbers and the applicable interest rate. For most of the relevant period, however, no one other than Mr. Ebbers' personal secretary kept track of what Mr. Ebbers was doing with the money he received from the Company.

The Examiner is troubled that the process surrounding the loans and guaranty was *ad hoc* and unstructured. Among other things, although the Compensation Committee initially authorized loans to Mr. Ebbers with the understanding that he would use the proceeds to address margin calls on his bank debt,[80] the promissory notes signed by Mr. Ebbers contained no limitation regarding his use of these funds. Thus, in several instances, Mr. Ebbers used the proceeds of loans made by WorldCom for purposes other than to meet margin calls on his outstanding bank debt. In particular, as described in the First Interim Report, during the period when WorldCom was extending Mr. Ebbers hundreds of millions of dollars in credit, he used more than $27 million to prop up his outside business interests or for other personal reasons. For example, during the lending period, Mr. Ebbers infused over $20 million into his shipyard and yacht sales business, which he presumably could not have done absent his ability to use the loan proceeds as he chose.

The Examiner also has questions regarding the reactions of members of the Compensation Committee and others who apparently became aware of Mr. Ebbers' use of loan

80 To that end, the Company made disclosures in public filings indicating that the purpose for the loans and guaranty was to repay lenders.

proceeds from WorldCom for purposes other than margin calls. In particular, Mr. Bobbitt told us that he learned of Mr. Ebbers' use of loan proceeds as working capital for his companies, particularly the shipyard, in late 2000 or early 2001. He said that, at the time, he thought the use was suitable to "maintain the value of [Mr. Ebbers'] real assets." Mr. Borghardt, an in-house lawyer and advisor to the Compensation Committee, also said that, because he believed it made sense to support Mr. Ebbers' business interests that were pledged as security for the WorldCom loans and guaranty, he was not particularly concerned about Mr. Ebbers' uses of loan proceeds as working capital when he learned of them it no later than August 2001. These reactions by persons charged with protecting the interests of WorldCom and its shareholders are curious and somewhat troubling for two reasons: (i) WorldCom did not even obtain security interests in these other businesses until 2002; and (ii) the Compensation Committee and its counsel should have known that Mr. Ebbers had pledged the same outside business assets to another lender in June 2001.

D. The WorldCom Board Shares Responsibility for the Loans and Guaranty

The Examiner does not want the foregoing discussion to suggest that all responsibility for problems related to the loans and guaranty rests with the members of the Compensation Committee. To the contrary, the Examiner observes that the entire Board bears a significant responsibility for these problems and the considerable losses sustained by WorldCom.

At a meeting held on November 16, 2000, Directors who were not members of the Compensation Committee were informed that the Company had extended $175 million of credit to Mr. Ebbers in the form of personal loans and a related guaranty. During recent interviews, several of these Directors indicated that they were deeply concerned about the loans and guaranty, both because the Compensation Committee had taken the action without prior Board approval and because Mr. Ebbers' need for such substantial financial assistance suggested that

WorldCom's CEO had taken imprudent action in his personal affairs, which had the potential to harm WorldCom's shareholders. A number of Directors stated that disclosure of the loans caused them immediately to lose significant confidence in Mr. Ebbers.

Given such views, the Examiner believes that a vigilant Board would have made inquiries about various issues, including why the Committee had acted without Board approval, what the terms of the loans were, whether there was assurance that the loans would be repaid, and whether the Company was prepared to consider additional loans or guaranties in the future, if needs arose. We have identified no evidence that such inquiries were made. Rather, our interviews, and the Acting Secretary's detailed notes concerning the November 16, 2000 Board meeting, reflect only that Mr. Kellett described the actions by the Compensation Committee and justified the loans and guaranty on the basis that the Committee feared a large sale of WorldCom stock by Mr. Ebbers would injure shareholders. Apparently, Mr. Bobbitt and Mr. Ebbers made the same point. There is no record of any other Director making a single comment and the Board set no guidelines regarding future loans or guaranties.

Similarly, we have investigated matters related to an Executive Session of the full Board, which occurred at the conclusion of the March 1, 2001 Board meeting. During this Executive Session, the Board ratified a $25 million loan to Mr. Ebbers made in December 2000, as well as the approximately $235 million guaranty extended to Bank of America on behalf of Mr. Ebbers on January 25, 2001. No Director had any comment about the increasing loans or guaranty and no one probed the Compensation Committee regarding its due diligence, security for the loans and guaranty, the prospects that Mr. Ebbers would repay the Company, the likelihood of additional loans or further extensions of the guaranty, or any other related matter.

The Board's apparent passivity and willingness to decide matters related to the loans based upon scant data is especially troubling during this period. By this time, WorldCom had agreed to loan Mr. Ebbers $100 million and the Company had issued a guaranty of over $200 million. Further, several Directors indicated that the loans caused them to question Mr. Ebbers and his leadership during this time frame. Few Directors attempted to defend the Board's inaction regarding these matters during our recent interviews. Rather, in explaining these matters, Directors acknowledged that WorldCom was still Mr. Ebbers' company and that the other Board members were not willing to take the chance of confronting him. The substantial corporate governance concerns that arise when the CEO turns to the Company as his private bank under those circumstances are manifest.

E. The Company's Public Disclosures Regarding the Loans to Mr. Ebbers

The Examiner also has reviewed matters related to the Company's public disclosures regarding its loans to Mr. Ebbers. In general, these disclosures reflect the blind deference to Mr. Ebbers and the absence of meaningful inquiry that marked virtually all conduct by Management and the Board related to the loans and guaranty.

One set of such disclosures raises particular concerns in the mind of the Examiner. On February 7, 2002, in an SEC filing on Form 8-K, WorldCom stated that "Mr. Ebbers . . . has provided information demonstrating that his assets are sufficient to cover his outstanding obligations to the Company."[81] The Examiner believes this statement, which outside counsel for

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81 Similar disclosure language also appeared in the Company's filing on Form 10-K for fiscal year 2001, dated March 13, 2002, and in proxy materials circulated by WorldCom in or about April 2002. In the April 2002 proxy, WorldCom modified this disclosure language to focus on Mr. Ebbers' pledged assets to WorldCom. This language states that "Mr. Ebbers … has provided information demonstrating that the pledged assets are sufficient to cover his outstanding obligations to us."

WorldCom described as "aggressive" and as designed to provide "assurance" to investors regarding the loans, was sloppy, unreasonable and inappropriate.

As discussed above, neither WorldCom Management, nor the Compensation Committee had obtained an independent valuation or adequate supporting documentation concerning the value of Mr. Ebbers' assets at the times of these disclosures. Instead, it appears that the Compensation Committee and others merely accepted at face value the financial information presented by Mr. Ebbers and, as acknowledged by Mr. Bobbitt during a recent interview, "relied on Mr. Ebbers' word."

The failure of WorldCom Management and the Board to obtain support for these disclosures is made more troubling by the fact that the Examiner has collected evidence that outside counsel for WorldCom stressed the need for supporting documentation before the Company made its disclosures in public filings. Further, it appears that WorldCom later failed to correct its disclosures regarding the sufficiency of Mr. Ebbers' assets when it subsequently learned that the statements were not supported. An outside lawyer for WorldCom recommended that the Company consider "some modification to put people on notice that they can't rely on the prior statement" and noted that the SEC had required such curative disclosures in other contexts. As a result of these concerns, WorldCom stopped using this disclosure language, beginning with a Form 8-K filed by the Company on May 20, 2002. However, the Company did not correct its earlier statements or notify investors regarding its concerns about the sufficiency of the collateral pledged by Mr. Ebbers.

VII. MR. EBBERS' FORWARD SALE OF WORLDCOM STOCK

As discussed above, in late September 2000, Mr. Ebbers made a request for a further loan from WorldCom, which was denied by Mr. Kellett, the Chairman of the Compensation

Committee. When the Committee refused to grant Mr. Ebbers the loan, Mr. Ebbers decided to sell a portion of his WorldCom stock to Bank of America in a forward sale, with September 28, 2000 listed as the trade date.[82] As a result of this forward sale, Mr. Ebbers received a payment of approximately $70.5 million. The sale was reported in the press on October 4, 2000. The price of WorldCom stock fell $2.25 the next day.

A. The Facts Surrounding the Forward Sale

Before engaging in the forward sale, Mr. Ebbers sought legal advice from Mr. Borghardt about the possible transaction. According to Mr. Borghardt, on September 26, 2000, Mr. Ebbers asked him the following question: if there was a forced sale of his WorldCom stock and WorldCom issued an earnings warning within a week or so would there be an insider trading issue? According to Mr. Borghardt, Mr. Ebbers described the forward sale as "forced" because Bank of America required cash from Mr. Ebbers to satisfy margin calls.[83]

Shortly after his initial conversation with Mr. Ebbers about the forward sale, Mr. Borghardt sought legal advice from outside counsel for WorldCom. Mr. Borghardt attempted to contact an attorney with whom he frequently consulted at a large law firm in St. Louis. When this attorney was not immediately available, Mr. Borghardt contacted attorneys at a New York City law firm, with whom he also worked on WorldCom matters. Ultimately,

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82 A forward sale is a complex securities transaction that requires delivery of a specified number of shares on an agreed-upon future date. In exchange, the seller receives an upfront payment (discounted from market value) and the opportunity to share in future appreciation of the stock depending on how the stock performs during the contract period. In this case, Mr. Ebbers agreed to sell to Bank of America on a forward basis, for settlement on or about March 28, 2002, up to three million shares of WorldCom common stock, with the actual number of shares to be delivered on the maturity date determined according to a pre-determined formula.

83 Mr. Ebbers' relationship manager at Bank of America disagreed with Mr. Ebbers' characterization of the forward sale as "forced" and noted that Mr. Ebbers had several different options in responding to the margin call. Also, a contemporaneous e-mail, dated September 25, 2000, indicates that Bank of America presented Mr. Ebbers with as many as ten different options that he could pursue to satisfy the margin call. At least one of these options did not involve the sale of WorldCom stock.

Mr. Borghardt received legal advice from both law firms. In fact, Mr. Borghardt had several conversations with attorneys at both firms about Mr. Ebbers' forward sale. Mr. Borghardt informed us that he asked both firms to address whether the "forced" nature of the forward sale changed any of Mr. Ebbers' obligations under the insider trading laws. He also stated that he advised outside counsel about the question Mr. Ebbers had asked him. Both law firms expressed concern about this transaction in light of insider trading laws. Mr. Borghardt recalls that the lawyers from the New York firm, in particular, expressed what he characterized as a "high" degree of concern.

After preliminary discussions with outside counsel about Mr. Ebbers' forward sale later on September 26, 2000, Mr. Borghardt told Mr. Ebbers that he should do everything he could to avoid this sale by selling assets other than WorldCom stock to meet the margin calls. Mr. Ebbers replied that his money was "tied up" in land and other assets and that, other than his WorldCom stock, he had "no other assets" that he could use to respond to the margin calls "quickly enough."

After hearing outside counsel's concerns about Mr. Ebbers' forward sale, Mr. Borghardt talked with Mr. Kellett the next day, September 27, 2000. It appears that Mr. Kellett discussed with Mr. Borghardt alternatives to a forward sale by Mr. Ebbers, including an additional loan from WorldCom. During this conversation, Mr. Kellett also observed that the timeframe of the contemplated forward sale fell during a "blackout" period in which senior executives of WorldCom could not trade in WorldCom stock.[84]

Bank of America had substantial experience with forward-sales transactions and insisted upon assurances from WorldCom that Mr. Ebbers' forward sale violated no insider trading laws

[84] During the relevant period, WorldCom's policy precluded senior executives from trading WorldCom stock within 30 days of an earnings report. At that time of Mr. Ebbers' forward sale, a WorldCom earnings report was scheduled to be released on October 26, 2000.

or WorldCom policies. On September 27, 2000, Bank of America sent Mr. Borghardt an e-mail copy of the "form of the issuer letter that we request in these transactions," which stated, among other things, that "[t]he Issuer [WorldCom] confirms that the Transaction … will not violate any insider trading or other policy of the issuer."

In marking up a draft of WorldCom's consent letter to Bank of America, Mr. Borghardt crossed out this statement on insider trading. Bank of America, however, insisted on language that Mr. Ebbers' forward sale complied with WorldCom policies and the securities laws. In a September 29, 2000 e-mail to Mr. Borghardt, Bank of America stated that "at a minimum" it required assurance that Mr. Ebbers complied with the applicable WorldCom policy on insider trading, including that he cleared the trade with the Chief Financial Officer. Mr. Borghardt and the bank agreed on alternative language stating that "[t]he Holder [Mr. Ebbers] complied with all applicable Issuer procedures prior to entering into the Transaction." Mr. Borghardt signed the consent letter on behalf of WorldCom.

B. Issues Presented by Mr. Ebbers' Forward Sale

Mr. Ebbers' forward sale presents a number of issues:

1. The Forward Sale Violated WorldCom Policy

Mr. Borghardt's representation to Bank of America, in the issuer consent letter, that Mr. Ebbers complied with all WorldCom procedures before entering the forward sale transaction appears to be incorrect. At the time, the senior executive trading policy for WorldCom stock stated that "there should be no trading within thirty (30) days prior to [an] earnings release." The policy, which was dated July 25, 2000, made no provision for any exception to this 30-day rule.

Assuming that September 28, 2000 (the date listed in the relevant documents as the trade date) is the pertinent date of the forward sale transaction, Mr. Ebbers traded WorldCom stock within the 30-day blackout period prior to the Company's Third Quarter 2000 earnings announcement on October 26, 2000. Mr. Sullivan himself enforced compliance with this policy in his dealings with another senior executive *on the same day a*s Mr. Ebbers' forward sale, noting, in a September 28, 2000 e-mail to a senior WorldCom executive, that the next earnings report would come on October 26, 2000 and that "[t]here is a prohibition [on trading WorldCom stock] thirty days prior to earnings." Further, less than three weeks earlier, on September 12, 2000, Mr. Sullivan emphasized WorldCom's trading policy to another senior executive. Mr. Sullivan unequivocally told this executive in an e-mail that "You CANNOT sell the underlying stock or any stock of WCOM thirty days prior to earnings." (emphasis in original). These communications strongly suggest that Mr. Ebbers' forward sale was a violation of WorldCom's trading policy.[85]

2. The Company Failed to Investigate Properly Whether Mr. Ebbers Possessed Material Non-Public Information

It appears that no one at WorldCom took steps to investigate properly the facts surrounding any material, non-public information in Mr. Ebbers' possession at the time of his forward sale. It also appears that Messrs. Borghardt and Sullivan, or others acting on their behalf, should have more carefully considered whether Mr. Ebbers possessed inside information. This investigation should have included specific inquiry of the information in Mr. Ebbers' possession concerning the potential earnings warning mentioned by Mr. Ebbers.

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[85] Our investigation also suggests that Mr. Borghardt was on notice that failures to abide by the Company's trading policy might involve violations of the federal securities laws. Highlighting the importance of compliance by insiders with the blackout policy, outside counsel had stated to Mr. Borghardt in connection with a different insider stock sale that from the SEC's standpoint, selling WorldCom stock "during a blackout period is a 10b-5 problem for that insider" (referring to Rule 10b-5 under the Securities Exchange Act of 1934).

a. Mr. Ebbers' Knowledge About an Upcoming Earnings and Revenue Warning Should Have Been Investigated

WorldCom experienced an earnings shortfall for the Third Quarter of 2000, which the Company announced on October 26, 2000. Prior to this shortfall, the consensus view among analysts was that WorldCom's Third Quarter earnings would be 47 cents a share. The actual announced earnings per share was 33 cents, an approximately 30 percent shortfall.

Available information suggests that Mr. Ebbers had access to financial information prior to the forward sale that placed him on notice of a likely earnings and revenue shortfall. In particular, Mr. Ebbers received and consistently reviewed the so-called MonRev reports that detailed WorldCom's monthly revenue. The August 2000 MonRev report was available on September 18, 2000, and, therefore, Mr. Ebbers had access to this report more than a week before his forward sale. The August 2000 MonRev report disclosed actual revenue from WorldCom's operations in the United States substantially below the budgeted expectations by $314 million (about a 10 percent shortfall). Furthermore, a few days before the forward sale, Mr. Sullivan sent Mr. Ebbers' secretary, among others, several e-mails indicating that WorldCom's revenue was lagging behind expectations and past performance, and that a substantial part of WorldCom's business "fit the lower current or future growth profile." Also, on September 23, 2000, in an e-mail addressed in the text to "Bernie," Mr. Sullivan sent a schedule showing negative revenue growth for each of the first three quarters of 2000 as compared with the first three quarters of 1999. These documents and communications suggest that Mr. Ebbers knew that an earnings shortfall was likely.

Moreover, by September 25, 2000, the day before Mr. Ebbers approached Mr. Borghardt regarding a "forced" sale of his WorldCom stock, Mr. Sullivan, and others under his direction, had started analyzing the impact on WorldCom's stock price of a public warning concerning declining growth rates. The analysis examined what happened at Sprint when that company issued a revenue warning and, applying the Sprint example to WorldCom, speculated that if WorldCom made a similar announcement, the Company's revenue growth rate and earnings per share could decline and the stock price could drop more than 10 percent.

Ultimately, on November 1, 2000, WorldCom did issue a revenue and earnings guidance warning, which noted that it anticipated declining growth that was well below Wall Street's expectations. For example, in its guidance, WorldCom estimated Fourth Quarter 2000 earnings per share in the 34 to 35 cents range, a figure well below the Wall Street estimate of $0.58 per share.[86] That day, WorldCom's stock declined 20 percent, a drop of $4.81.

Notwithstanding the negative financial information available to Mr. Ebbers, the Examiner has seen no evidence that anyone at WorldCom investigated his knowledge of a potential earnings and revenue warning prior to the forward sale. Indeed, Mr. Borghardt has acknowledged that he never questioned Mr. Ebbers about the financial information in his possession or checked with finance or accounting personnel about WorldCom's expected financial performance for the Third Quarter of 2000. Given the specificity of Mr. Ebbers' question regarding a potential earnings warning and the timing of the forward sale just a few days prior to the end of the quarter, at a minimum, the Examiner believes Messrs. Borghardt and Sullivan should have closely questioned Mr. Ebbers about his possession of non-public information.

[86] Similarly, in its guidance, WorldCom estimated its earnings per share for FY 2001 at $1.60, which was about 33 percent below the Wall Street estimate of $2.40.

b. The Company Should Have Analyzed the Materiality of its Recent Loan to Mr. Ebbers

An additional matter pertinent to the forward sale concerns Mr. Ebbers' loans. On September 6, 2000, Mr. Ebbers had received a $50 million loan from WorldCom. Mr. Sullivan was aware of that loan, and Mr. Borghardt became aware of it no later than September 26, 2000. In terms of WorldCom's overall finances as of September 2000, a $50 million loan may not have been quantitatively material. However, for the investing public, the fact that the CEO of WorldCom faced substantial margin calls and needed to resort to a Company loan in the amount of $50 million may well have been material information. This information was not publicly disclosed until November 14, 2000, well after the forward sale transaction.

The Examiner has investigated to determine whether any consideration was given to the $50 million loan in the context of the forward sale. Mr. Borghardt advised that he did not consider the possibility that the loan was material, non-public information that might affect the propriety of the forward sale. He likewise did not discuss the loan with the outside law firms he consulted regarding the proposed forward sale. In a recent interview, one of the outside attorneys consulted by Mr. Borghardt commented that if the loan had been mentioned to him at the end of September 2000, as he considered Mr. Borghardt's inquiries about the forward sale, he believes he would have advised Mr. Borghardt that the $50 million loan could be viewed as material, non-public information.[87]

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[87] In a November 8, 2000 memo to Mr. Borghardt, this outside lawyer indicated that other companies had publicly disclosed loans to high-ranking executives far smaller than the loans to Mr. Ebbers in their SEC filings on Forms 10-K and 10-Q. In connection with his work on this matter, the lawyer compiled a survey of loans that other companies had made to high-ranking executives that he attached to this memo. The survey suggested that the largest amount loaned to a single executive was $7.5 million, which is much less than the initial $50 million loan to Mr. Ebbers. This counsel recommended that WorldCom disclose the loans and guaranty in the Form 10-Q for the Third Quarter of 2000 (filed on November 14, 2000), which WorldCom did.

c. The Company Should Have Analyzed the Materiality of the Tracker Stocks

WorldCom's active consideration of the Tracker stock proposal for WorldCom and MCI also may have constituted material inside information possessed by Mr. Ebbers at the time of the forward sale. After the Sprint merger fell through, WorldCom embarked on a campaign to restructure the Company in an attempt to stem its eroding share price. This campaign began with a July 27, 2000 conference call in which Mr. Ebbers announced Tracker stocks as one of four options under consideration for a major financial restructuring of WorldCom. He also made clear at the time that the Company had not decided which option to pursue. By the time of Mr. Ebbers' forward sale, however, it appears that WorldCom had decided to pursue the Tracker stocks.

On our about September 27, 2000, Mr. Borghardt discussed with Messrs. Bobbitt and Kellett that WorldCom had compiled a report analyzing the performance of Tracker stocks at other companies by no later than early September 2000. Mr. Kellett also indicated that WorldCom might announce that it would adopt the Tracker stock structure by early October. During this same timeframe, WorldCom and its consultants drafted detailed presentations on the Tracker stock structure, including a September 28, 2000 memo entitled "Potential Questions and Answers Regarding Tracking Stock Issuance," which was intended to provide answers to questions by investors about the Tracker stocks. Moreover, Mr. Hamilton, who was the Company's head of investor relations during the relevant period, informed us that by late September 2000 he understood the decision had been made to adopt Tracker stocks.[88]

[88] Chapter IV.D.4.c provides additional information suggesting that WorldCom had decided to pursue the Tracker stocks prior to Mr. Ebbers' forward sale.

Because Mr. Borghardt knew of the Tracker stock proposal prior to the forward sale, at a minimum, he or others acting on his behalf should have analyzed whether this represented material, non-public information possessed by Mr. Ebbers. The Tracker stock proposal was a major restructuring, which could have been viewed by the market as signaling management's recognition that the Company was in financial trouble. Indeed, in an interview with the Examiner, Mr. Grubman, a telecommunications research analyst who covered the Company for SSB, claimed that he was "never a fan" of Tracker stocks for that reason. Yet, no one at WorldCom, including Messrs. Borghardt and Sullivan appears to have considered whether Mr. Ebbers possessed material non-public information regarding the Tracker stocks at the time of the forward sale. It also appears that Mr. Borghardt never discussed this proposal with the two law firms he consulted on Mr. Ebbers' forward sale.

3. The Process for Clearing Mr. Ebbers' Forward Sale Was Flawed

According to Mr. Borghardt, Mr. Sullivan cleared Mr. Ebbers' forward sale. Mr. Borghardt indicated that Mr. Sullivan stated that he spoke with Mr. Ebbers and that Mr. Sullivan was satisfied that Mr. Ebbers possessed no material, non-public information at the time of the forward sale. Mr. Ebbers also stated that Mr. Sullivan assured Mr. Ebbers that he knew of no material non-public information possessed by Mr. Ebbers at the time of the forward sale.

Mr. Borghardt explained that he felt comfortable about Mr. Ebbers' forward sale based on the representations of Mr. Ebbers and Mr. Sullivan that Mr. Ebbers possessed no material, non-public information about WorldCom. Yet, Mr. Borghardt's description of Mr. Sullivan's lack of concern may be seemingly contradicted by a discussion of another forward sale by a Board member about a month later. In that context, Mr. Sullivan left a message on Mr. Borghardt's voice mail stating that Mr. Sullivan viewed the decision to clear Mr. Ebbers' forward sale as a "tough call." Further, Mr. Borghardt never questioned Mr. Sullivan about Mr. Ebbers' knowledge of the potential earnings and revenue warning, the $50 million loan, or the tracking stock proposal. Nor did he ascertain whether Mr. Sullivan discussed these issues with Mr. Ebbers.

For the reasons described above, the Examiner is troubled because there apparently were several "red flags," which suggested that Mr. Ebbers may have possessed material, non-public information at the time of the forward sale. Nonetheless, Mr. Borghardt failed to explore these matters internally or with outside counsel, and instead, apparently deferred to Mr. Sullivan. The Examiner believes that it was problematic for Mr. Borghardt to have relied on the judgment of a non-lawyer in clearing this transaction. Rather, the situation called for Mr. Borghardt to apply his own legal judgment, particularly because Mr. Ebbers had approached him for legal advice about the forward sale and because outside counsel had told Mr. Borghardt of their concerns regarding with the sale.

VIII. PERSONAL ENRICHMENT AND COMPENSATION MATTERS

A. Introduction

In the Examiner's First Interim Report, the Examiner outlined the preliminary results of his investigation into issues of monetary and non-monetary compensation at the Company during the period January 1999 through July 2002. The First Interim Report suggested that the lack of objective, internal controls over compensation decisions created a system with significant potential for abuse. In this Second Interim Report, we describe in some detail the remarkable concentration of power and authority in one man, Mr. Ebbers, that colored almost every aspect of compensation decision-making at the Company, and point out corporate governance shortcomings that precluded any effective restraint on Mr. Ebbers' power.

Although the Examiner has fairly exhaustively investigated the process by which the Company (or Mr. Ebbers) determined employee compensation, the Examiner is still exploring the end result of this process. More specifically, the Examiner is continuing to evaluate whether (a) the Company used compensation as a means of ensuring employee loyalty to key Executives (especially to Mr. Ebbers and to Mr. Sullivan); and (b) whether Company employees received excess compensation for participating in, or failing to disclose, fraudulent activity or other misconduct or neglect at the Company.

Both of these issues require the Examiner to probe the compensation of a huge number of Company employees in order to determine how each employee's compensation compares to his or her peers in the Company and to the various guidelines that the Company imposed on different types of employee compensation. Logistics, data maintenance and retrieval issues, and reliance on the Company for compensation data, have combined to prevent quick answers to these queries.[89]

Nevertheless, the Examiner has uncovered information showing that various Company employees who were in a position to know about the accounting fraud and other misconduct and neglect described elsewhere in this Report, some of whom already have pled guilty to criminal charges arising out of the fraud, routinely received compensation in excess (sometimes well in excess) of Company-imposed guidelines. The Examiner has also learned that Mr. Sullivan wrote a number of personal checks in the amount of $10,000 each to key subordinate employees and their spouses during the time that he was allegedly engaged in the accounting fraud.

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[89] The Examiner must, of necessity, rely on WorldCom for information about employee compensation. Therefore, all conclusions about actual employee compensation hinge on the accuracy and completeness of the information provided by the Company.

The following sections address primarily the "process" issues noted above. Where possible, we also include specific examples of employee compensation that calls into question whether certain individuals exploited the lack of internal controls in the Company's compensation system to achieve improper goals.

B. Overview of the Compensation Process at WorldCom

The compensation of certain Management-level employees took three basic forms: salary, bonus, and stock options.[90] As the following sections demonstrate, however, the process by which the Company determined each element of compensation varied significantly depending on an employee's grade, or level, within the Company. More important, the "theory" of compensation decision-making at the Company did not always correspond to its reality. While the Compensation Committee was supposed to either make or monitor compensation decisions, its members abdicated their responsibilities and Mr. Ebbers effectively made the decisions.

1. Senior Executives

In theory, the Compensation Committee determined the salary, performance bonus, and stock option grants for each of the Company's Senior Executives, including, among others, the Chief Executive Officer (Mr. Ebbers), the Chief Financial Officer (Mr. Sullivan), and the Chief Operating Officer (as of January 1, 2001, Mr. Beaumont). In practice, Mr. Ebbers had substantial discretion to determine compensation for every Senior Executive other than himself.

2. The "Restricted Group"

Immediately below the Company's Senior Executives was a level of Management extending down to Senior Vice-Presidents and comprising 30 to 40 individuals. This set of

[90] As discussed in more detail below, employees in the sales divisions received quarterly commission bonuses, while other WorldCom Management employees received yearly performance bonuses.

Executives, sometimes referred to as the "Restricted Group," consisted primarily of employees who reported directly either to Mr. Ebbers himself or to another Executive who reported directly to Mr. Ebbers.

In theory, the Compensation Committee was supposed to monitor the compensation process for these Executives by "reviewing and taking action concerning" issues relating to their salary, bonuses, and stock options grants.[91] In practice, however, the Compensation Committee did not monitor this process. Rather, Mr. Ebbers completely controlled it and he did so in the absence of any written policies or procedures for determining Restricted Group compensation.

3. Remaining Non-Sales Employees

For all non-sales management employees below the level of Senior Vice-President, the Company established guidelines, or limits, both on employee salaries at each "grade," and on raises, bonuses, and stock option grants at each grade. In theory, the Human Resources Department was supposed to issue written policies that dictated both the amount, or range of each type of compensation and the manner in which the Company determined it, and the Compensation Committee was supposed to monitor this process.

In practice, however, the Compensation Committee had essentially nothing to do with the compensation or process for these lower-level management employees. Mr. Ebbers retained both the ultimate authority to approve the guidelines and the ability to change compensation decisions for this group of employees.

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91 With respect to Restricted Group compensation, the Company's proxy statements stated that the Compensation Committee was "to review and take actions, including submission of recommendations to the Board of Directors, concerning compensation, stock plans and other benefits for the Company's directors, officers and employees."

4. Sales Employees

At least until late 2001, the Company determined compensation for its sales employees under a dizzying array of commission programs that practically invited, and in fact resulted in, fraud and abuse. Moreover, our investigation to date suggests that no one was monitoring the compensation of sales employees, including the Compensation Committee, Senior Management, or the Human Resources Department.

The different processes by which the Company determined compensation for its various employees are discussed below, including any apparent problems or flaws inherent in those processes. When appropriate, examples are provided of possible abuses and of the personal enrichment that resulted from the lack of firm policies, procedures, and oversight.[92]

C. The Compensation of Senior Executives at the Company

1. Overview of the Compensation Committee's Role

As noted above, the Company's proxy statements indicate that the Compensation Committee had sole authority to set the compensation of the Company's Senior Executives.[93] During the relevant time period, the Compensation Committee consisted of four official

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[92] Some of the information included in this Report comes from Compensation Committee Meeting Minutes. Reliance on these Minutes is problematic, however, because they are surprisingly sparse, including mostly conclusory statements, which are generally unrevealing.

Also, Compensation Committee members have told counsel for the Examiner about Compensation Committee decisions that are inaccurately reflected in the Minutes, or are not reflected at all. For example, there is evidence – including from interviews and handwritten notes – that the Compensation Committee authorized a $2 million dollar bonus for Mr. Sullivan in 2001 but that Mr. Ebbers refused to permit the Company to pay it. Oddly, the granting of the bonus is not included in the official Minutes of the relevant Compensation Committee meeting.

[93] The Compensation Committee determined the compensation of the Company's top 4 or 5 Senior Executives each year. In 1999, these executives were Messrs. Ebbers, Roberts, Sidgmore, Sullivan, and Price. The 2000 list included the same Executives, with the exception of Mr. Price. Mr. Beaumont replaced Mr. Sidgmore on this list in 2001, which remained the same until Mr. Ebbers left the Company in April 2002.

members: Stiles A. Kellett, Jr., Max E. Bobbitt, Gordon S. Macklin, and Lawrence Tucker, the latter of whom became an “advisory member” in November 2000.

During the course of the investigation, the Examiner interviewed these four former Compensation Committee members, all of whom have stated that the Compensation Committee took seriously its role as arbiter of compensation for the Company's Senior Executives and denied that Mr. Ebbers ever dictated compensation packages for this group. At the same time, however, every former member acknowledged Mr. Ebbers' unique role in the compensation process and conceded that Mr. Ebbers' "recommendations" were of "paramount importance" in determining Senior Executive compensation.

In fact, the Chairman of the Compensation Committee admitted that he viewed Mr. Ebbers as having ultimate authority to determine the salaries of all Senior Executives of the Company, other than Mr. Ebbers himself. Moreover, another former Compensation Committee member, in discussing the deference the Board of Directors gave to Mr. Ebbers generally, referred to Mr. Ebbers as “God,” “Jesus Christ,” and “Superman.” The same former member said of the Board of Directors, “we were not there to second-guess our leaders [Messrs. Ebbers and Sullivan.]”

2. The Mechanics of Senior Executive Compensation

There were three general elements of compensation for Senior Executives: salary, annual incentive compensation (executive performance bonus), and long-term incentive compensation (stock option grants). Between January 1999 and December 2001, compensation for these individuals was quite substantial. Mr. Ebbers, for example, received a total of $20.5 million in cash and over 4 million stock options, valued at approximately $55 million during this time period.

a. Salary

During the relevant time period, salary played a relatively small role in total Senior Executive compensation and did not vary much year-to-year. In fact, Compensation Committee-approved salaries for these Executives remained relatively consistent for the period 1999 – 2002:

- The salaries for Mr. Ebbers ($1 million) and Bert C. Roberts ($1.05 million) did not change at all.
- Mr. Sullivan saw his salary increase from $600,000 in 1999 to $700,000 in 2000, where it remained through the time of his dismissal in 2002.[94]
- Mr. Sidgmore saw an identical jump from $600,000 to $700,000 in 2000, his last year in this group.
- Mr. Beaumont’s salary was established at $675,000 for both of his two years in this group (2001 and 2002).

The Company's proxy statements reported that when setting Senior Executive salary ranges, the Compensation Committee looked at two factors: (1) the level and scope of the responsibility attached to a particular position; and (2) the salaries of similarly-positioned officers in comparable companies.[95] With regard to actual salaries within the established ranges, the Compensation Committee was to evaluate the following factors:

- Company performance, as evidenced by changes in the price of the Company's common stock compared to that of industry competitors;
- the CEO's recommendations with regard to other Senior Executives;
- each officer's individual performance;
- any significant changes in the officer's responsibilities; and

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[94] Although the Company's 2000 Proxy Statements lists Mr. Sullivan's salary for 1999 as $600,000, internal Company data shows a salary of only $500,000.

[95] To date, the Examiner has not found any evidence that the Compensation Committee established salary ranges. Rather, Mr. Ebbers provided the Committee with his "recommendations."

- each officer's then-current salary.

The proxy statements also stated that among these five factors, the Compensation Committee found Mr. Ebbers recommendations to be of "paramount importance." Although the Examiner has uncovered no evidence to refute the notion that the Compensation Committee actually considered these factors when establishing Senior Executive compensation, several aspects of the process cast doubt on the Compensation Committee’s ability to check independently Mr. Ebbers’ influence in this area. First, it was Mr. Ebbers who approached the Compensation Committee with compensation recommendations for the Senior Executives, not vice versa. As noted above, the Compensation Committee viewed these recommendations as being of “paramount importance” in their deliberations. Second, Mr. Ebbers was the sole source of much of the information on which the Compensation Committee ostensibly relied when reviewing those recommendations, including (a) an assessment of the senior Executive’s level of responsibility; (b) an appraisal of the senior Executive’s performance; and (c) the actual salary recommendation. Third, the only evidence the Examiner has identified relating to external salary surveys consists of some charts, created in 1999, that tabulate executive compensation information from the proxy statements of other public corporations that the Compensation Committee determined were “comparable” to WorldCom. Although one former Compensation Committee member indicated that he had prepared similar charts in other years, the Examiner has been unable to locate them and none has been produced. Fourth, none of the former Compensation Committee members interviewed could recall, or cite to, a single instance where the Compensation Committee changed any of Mr. Ebbers’ salary recommendations. Fifth, the Examiner has learned of at least one instance where the Compensation Committee was interested in reducing the salary of a Senior Executive and Mr. Ebbers forbade it.

In sum, based on information currently known by the Examiner, Mr. Ebbers, and not the Compensation Committee, played the most significant role in determining Senior Executive salaries at the Company.

b. Senior Executive Performance Bonuses

Near the beginning of each year, the Compensation Committee established a performance bonus plan for the Senior Executives within its direct purview. The plan included a threshold trigger that would permit payment of performance bonuses if the Company met a specified goal for revenue growth. The plan also set forth dollar value limits on the bonuses as the greater of $1 million or 150 percent of the previous year's bonus. Toward the end of the year, the Compensation Committee would then determine whether the performance criterion had been satisfied and, thus, whether to award bonuses.

In 1999, the Compensation Committee determined that the criterion had been met and, accordingly, awarded bonuses to the Senior Executives totaling $18.9 million. Of this amount, Mr. Ebbers was awarded $11.5 million and Mr. Sullivan was awarded $2.76 million.[96] Although the Compensation Committee made the same determination in 2000, it awarded no performance bonuses in light of the Company's falling stock price.[97]

The situation in 2001 is somewhat murkier. Minutes of the meetings of the Compensation Committee indicate that a decision was made not to award any "performance bonuses" to the three eligible Senior Executives: Messrs. Ebbers, Sullivan, and Beaumont.

[96] Once again, the amount of the bonus awards stated in the Compensation Committee Meeting Minutes is different from what the Company reported in the proxy statements. According to the 2002 Proxy Statement, the Compensation Committee awarded Mr. Ebbers a performance bonus of $11.5 million," but Mr. Ebbers accepted only $7,500,000 of such an award."

[97] Despite the lack of performance bonuses, however, Senior Executives did receive substantial "retention bonuses" in 2000. We address the retention bonus issue later in this Report.

Nonetheless, the Minutes then reflect that the Compensation Committee awarded Mr. Beaumont a $2 million bonus, "based on individual performance and other circumstances." The Compensation Committee did not identify these "other circumstances."[98]

Perhaps equally curious is the "phantom bonus" awarded to Mr. Sullivan in 2001. According to two former Compensation Committee members, the Committee awarded Mr. Sullivan a $2 million "performance bonus" at the same time it awarded Mr. Beaumont his "special circumstances" bonus. Oddly, the meeting minutes of the Compensation Committee do not reflect this action, but the awarding of Mr. Sullivan's performance bonus is identified in the handwritten notes of Mr. Borghardt taken contemporaneously at the meeting. These former Compensation Committee members believe that Mr. Ebbers ultimately denied Mr. Sullivan this Compensation Committee-approved bonus out of jealousy or anger, because the Compensation Committee did not award a bonus to Mr. Ebbers that year, and that he then had the Minutes "sanitized" to eliminate any reference to a bonus award to Mr. Sullivan.

c. Senior Executive Stock Option Program

i. Mr. Ebbers' Authority Over Option Grants

Although the Compensation Committee had explicit authority to award stock options to all of the Company's Senior Executives, it deferred entirely to Mr. Ebbers in this regard.[99] Indeed, the Compensation Committee did nothing more than allocate a specific number of options to Mr. Ebbers each year, then approve stock option awards for other Senior Executives "as recommended by Mr. Ebbers." The Compensation Committee even granted Mr. Ebbers the

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[98] While the minutes of the pertinent meetings of the Compensation Committee and the Company's proxy statements disclosed the $2 million figure, the Company provided the Examiner with data showing that Mr. Beaumont actually received a bonus of $2.45 million in 2001.

[99] Former Compensation Committee members and other Company employees told the Examiner that Mr. Ebbers had exclusive authority to determine option grants.

authority to determine the vesting of those stock options. By giving Mr. Ebbers the authority to determine option recipients, the amount of each option award, and the vesting schedule, the Compensation Committee effectively ceded to Mr. Ebbers all authority to determine option grants to Senior Executives of the Company.

This abdication of responsibility is significant because options were supposed to be the largest portion of Senior Executive Compensation. Indeed, one former Compensation Committee member described the Committee's devotion to stock options as a "religion" at the Company. Assuming this was the case, Mr. Ebbers' unquestioned control over this compensation tool becomes even more significant.

ii. Mr. Ebbers' Influence Over Option and Stock Sales

For his part, Mr. Ebbers took full advantage of his preeminence in the realm of stock option grants by using stock options as a substitute for higher salaries, then trying to dissuade employees from selling their stock. For example, Mr. Ebbers apparently received a daily list of all employees who exercised options and sold the underlying stock. Mr. Ebbers would on occasion call employees to inquire about the stock sales. Mr. Ebbers discouraged all levels of employees, including senior Management, against stock sales. Thus, when Mr. Beaumont needed money to pay contractors who were working on a ranch he owned, Mr. Ebbers discouraged him from selling his stock and steered him to a bank where Mr. Beaumont obtained a line of credit and used his Company shares as collateral.

When WorldCom stock began to decline in value, however, Mr. Beaumont found himself in need of funds to cover the collateral requirements. Knowing Mr. Ebbers' policy against employees selling Company stock, Mr. Beaumont sought a loan from the Company in or about October 2000. Both at this time, and in early 2002 when Mr. Beaumont had to make certain tax payments relating to his ranch, Mr. Ebbers told Mr. Beaumont that he could not borrow the money from the Company and, instead, personally lent Mr. Beaumont a total of $650,000.[100] Mr. Beaumont still owes Mr. Ebbers this money.

Mr. Sullivan was not quite so observant of Mr. Ebbers' "no stock sale" policy. Between 1997 and August 2000, Mr. Sullivan made approximately $29 million from exercising vested options and selling approximately $44 million of the underlying WorldCom stock.[101]

3. Conclusions Regarding Senior Executive Compensation

In sum, the evidence shows that Mr. Ebbers was dominant in matters of Senior Executive compensation. For example:

- In setting Senior Executive salaries, the Compensation Committee considered Mr. Ebbers' recommendations to be of "paramount importance," despite the Committee's sole authority to determine such salaries.
- In awarding Senior Executive performance bonuses, the Compensation Committee deferred completely to Mr. Ebbers' recommendations, or at least acquiesced.
- In setting Senior Executive stock option grants, the Compensation Committee simply deferred to Mr. Ebbers entirely, at least as to Senior Executives other than Mr. Ebbers himself.

The Examiner recognizes that there is not necessarily anything wrong with a compensation committee giving some measure of deference to the wishes of a CEO. In WorldCom's case, however, the Company led the public to believe that the Compensation Committee served as an independent check on Mr. Ebbers' authority, when, in fact, it appears that Mr. Ebbers ultimately controlled all matters related to Senior Executive compensation.

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[100] Ironically, at the time Mr. Ebbers told Mr. Beaumont that he could not borrow money from the Company, Mr. Ebbers had just borrowed $50 million from WorldCom.

[101] Some former Compensation Committee members said that they were displeased about Mr. Sullivan's extensive sales of stock, but that they never spoke to him about it.

D. Compensation of "Restricted Group" Executives at the Company

1. Mr. Ebbers' Absolute Discretion

As noted above, the "Restricted Group" of Executives generally included individuals at the level of Senior Vice President and above, all of whom reported directly to Mr. Ebbers or to one of Mr. Ebbers' direct reports. The name "Restricted Group" arose from the fact that only Mr. Ebbers had routine access to the actual compensation of these Group members. In fact, even the head of the Human Resources Department was for a time precluded from viewing compensation information for the Restricted Group.

Like "Senior Executives," the Restricted Group received a combination of salary, bonus and stock option grants. Unlike the Senior Executives, however, the Restricted Group was outside the purview of the Compensation Committee. Instead, Mr. Ebbers determined salary, bonus and option grants for this group, either entirely on his own or in response to recommendations from one of his direct reports who supervised the group member at issue. The Examiner's review of evidence to date suggests that Mr. Ebbers used no formal criteria or procedures for setting Restricted Group compensation or for evaluating those compensation recommendations that his direct reports made to him.[102] Indeed, the executive who interacted most closely with Mr. Ebbers on compensation issues stated that, to the best of his knowledge, no one ever questioned the process Mr. Ebbers employed, or the decisions he reached, on Restricted Group compensation. In short, compensation for the Restricted Group apparently was wholly discretionary with Mr. Ebbers.

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[102] At least one member of the Restricted Group told the Examiner that he had never received a formal evaluation from Mr. Ebbers, had never discussed his compensation with Mr. Ebbers, and had learned that his compensation had been changed only when he saw a different number on his paycheck. Other members of this Group have confirmed that Mr. Ebbers never told them how he had calculated their compensation.

2. Restricted Group Compensation: Preliminary Findings

The Examiner's investigation into actual Restricted Group compensation is still in its early stages because the process of collecting this information from the Company and verifying it against existing Company records is logistically complicated and time-consuming. Moreover, due to the Company's complex, ever-changing and, in certain respects, unreliable data system, the Examiner repeatedly has received inconsistent compensation data from the Company. At this point, the Examiner can make only general observations about absolute (as opposed to relative) compensation values for certain "Restricted Group" employees.

Specifically, our preliminary analysis of data for certain direct reports to Mr. Sullivan shows notably high compensation awards, including: (a) annual merit salary increases of up to 21 percent (as compared to policy guidelines of between zero and 9.5 percent for employees below the Restricted Group level); plus (b) yearly performance bonuses comprising 30 to 50+ percent of annual salary; plus (c) stock option grants exceeding 300,000 per employee for the years 1999 through 2001. The Examiner is continuing to investigate any relationship between these compensation numbers and the employees' participation in, or knowledge of, accounting fraud or other misconduct at the Company.

E. Compensation of the Remaining WorldCom Employees

1. Compensation of Non-Sales Employees[103]

a. Overview of the Players and the Policy

In contrast to the discretionary compensation process for Executives, the Company had detailed written guidelines for determining the compensation of most other non-sales employees,

[103] Throughout this section of the Report, we refer to the policies and procedures in place during the relevant time period of our inquiry in the past tense. The Examiner understands, however, that many of these policies are still in place today.

which the Human Resources Department largely developed and implemented. As a baseline for establishing compensation levels, the Human Resources Department established a three-part indicator, known as a "job grade." Every Company employee had a job grade, and each job grade corresponded to a specific salary range, merit increase range, bonus range and grant of stock options. In other words, one needed only to look at an HR-generated table (or matrix) to determine a given employee's permissible salary, maximum merit salary increase, maximum bonus, and maximum options grant for a given year.

The Human Resources Department did not generate these tables in a vacuum. Although Mr. Ebbers exercised much less control over the compensation of these lower-level employees than he did over the compensation of Senior Executives, he did review, approve, and occasionally change, the policies of the Human Resources Department prior to implementation.

Mr. Ebbers was not supposed to exercise this power unimpeded, however. According to the Company's proxy statements, the Compensation Committee had the designated power to review and to take action "concerning compensation, stock plans and other benefits for the Company's directors, officers and employees." Compensation Committee Meeting Minutes reflect that the Committee paid little or no attention to this task, however, a fact that the Examiner has confirmed through interviews with former Compensation Committee members. Indeed, despite claims in the Company's proxy statements that the Compensation Committee independently monitored compensation decisions at the Company, three former Compensation Committee members denied that such "monitoring" was ever part of the Committee's duties.

b. Out of Policy Awards

i. The Policy

Management compliance with the Human Resources tables resulted in normal, or "in policy," compensation awards. With appropriate justification, however, supervisors could recommend so-called out-of-policy salary increases, performance bonus awards and stock option grants that went beyond the limits of the Human Resources guideline tables. Both the employee's business unit management and the Human Resources Department had to approve any such awards, including all "salary adjustments, which were raises occurring during the year outside of the normal review and compensation process." The Human Resources Department did not, however, prescribe what would constitute sufficient justification to support an out-of-policy award, and in practice, such justifications differed greatly. According to interviews with Human Resources Department personnel, Mr. Ebbers participated actively in this process by reviewing – and ultimately approving or denying – a significant percentage of these out-of-policy requests.

ii. The Practice

The Examiner is currently investigating out-of-policy compensation awards to individuals who were in a position to participate in the accounting fraud and other misconduct at WorldCom. Preliminary analysis suggests that, in the three years leading up to the Company's bankruptcy, many of these individuals in fact received out-of-policy compensation awards, with, at best, minimal justification from their ultimate superior, Mr. Sullivan.[104] For example:

- Between 1999 and 2001, at least ten of Mr. Sullivan's subordinates received out-of-policy merit raises, most more than once, and some at levels more than five to six times the policy limit.[105] Several of these persons have since pled guilty to criminal fraud charges.

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104 The Examiner has also uncovered what appear to be instances of actions taken without proper authority. For example, an exchange of voice mail messages between Mr. Sullivan and one of his subordinates details the granting of an extension of option vesting for four legacy WorldCom employees. It does not appear, however, that either Mr. Sullivan or his employee had the authority to grant such an extension. In theory, only the Compensation Committee could extend the option vesting period under the Stock Option Plan.

105 One subordinate received a merit raise of 24 percent, when he was entitled to no merit raise at all.

- Between 1999 and 2002, at least four of Mr. Sullivan's subordinates obtained out-of-policy bonuses, with one at 43 percent more than the maximum allowable bonus for the job grade. Again, some of these recipients have since pled guilty to criminal fraud charges.

- Between 1999 and 2001, at least ten of Mr. Sullivan's subordinates collected stock options that exceeded the Company maximums for their job grades, some at up to five times the permissible level. Although the Examiner has not identified any evidence linking these options to any illegal conduct, some of these subordinates pled guilty to criminal fraud charges.

iii. The Investigative Problem

Regrettably, the lack of any Company-wide procedure for retaining documents relevant to out-of-policy compensation decisions has severely hampered the Examiner's inquiry into the merits of specific awards. Through contact with the Company's Human Resources Department, the Examiner has learned that the Company can retrieve written out-of-policy justifications from its online system only for the current year. The Company does not retain historical information, even for the immediately preceding year. Moreover, the Company apparently had no policy that would require supervisors to place hard copies of out-of-policy adjustments, or the justifications therefore, in an employee's personnel file. The Examiner is exploring other means of obtaining this information.

2. Compensation of Sales Employees

Unlike all other Company employees, sales employees typically received quarterly performance-based commissions, rather than annual performance bonuses. In general, sales management would calculate these commissions using objective criteria from what, as late as 2001, were literally scores of different commission and incentive programs. Some of these programs, developed in different companies and for various personnel over time, covered no more than a handful of people each.

In 2001, the Company's Internal Audit Department uncovered substantial fraud and abuse in the Company's myriad commission programs. As a result, the Company began streamlining the commissions system by dramatically reducing the number of commission plans in existence. The Examiner's investigation to date suggests that, prior to this audit, the Company's rapid, acquisition-driven expansion, combined with a lack of rigorous integration efforts and slack attention to good corporate governance practices, created an environment where sales personnel could, and did, manipulate the commission system for personal gain.[106]

F. The May 2000 Retention Bonus Program

In May 2000, the Company awarded 558 WorldCom executives some $240 million in cash retention bonuses, along with 10.4 million shares of stock options.[107] The May 2000 Retention Bonus Program serves as a graphic illustration of the weak oversight and excessive deference to Mr. Ebbers that is detailed above.

1. The Concept of the Program

In the late 1990s, mid-level managers approached Senior Management to complain that they were having difficulty keeping their business units operating efficiently because so many employees were leaving for the "greener pastures" of high-tech, and start-up companies. Senior Management at the Company, including Mr. Ebbers, his Senior Executives and managers in the Human Resources Department, took these complaints to heart and, between late 1999 and early 2000, met to discuss the problem and to evaluate possible responses.

Ultimately, Mr. Ebbers decided to offer certain employees retention bonuses in exchange for their promise to remain at the Company for at least of two years, beginning in July 2000. As

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[106] It appears that the problems related to the compensation of sales employees have been rectified. Accordingly, the Examiner is not pursuing these issues.

[107] This amount does not include the $10 million bonuses paid to both Mr. Ebbers and Mr. Sullivan.

with all other compensation-related decisions at the Company, the final contours of the Retention Bonus Program remained firmly in Mr. Ebbers' hands.

In terms of the amount of the retention bonus, Mr. Ebbers decided to apply a "multiplier" to the total annual compensation of each eligible employee, based on the employee's level of responsibility within the Company. Thus, Senior Vice Presidents would receive a bonus of up to 3 to 3.5 times their annual compensation; Vice Presidents would get up to 2 to 2.5 times their annual compensation; and Senior Directors would receive up to two times their annual compensation.

All of these figures were presumptive, in that each employee's supervisor could propose a smaller retention bonus. Of course, Mr. Ebbers eventually reviewed every retention bonus recommendation and even changed certain awards before announcing them to the affected employees. According to some Company employees, Mr. Ebbers reviewed retention bonus recommendations to make sure that managers were not discriminating against employees who had not come from the same "legacy" company as the manager.

2. Analysis and Approval of the Program

The evidence that the Examiner has reviewed to date suggests that Mr. Ebbers generated these bonus multipliers without performing or reviewing any market survey of retention compensation at peer companies,[108] without any internal or external professional review of his analysis, and without any meaningful consultation with the Board of Directors.

The Compensation Committee apparently approved the Retention Bonus Program during a meeting on April 7, 2000. Neither the Meeting Minutes nor interviews with former

[108] One former member of the Compensation Committee said that Mr. Ebbers did present the Committee with information regarding retention bonuses at comparable companies. No other members of the Committee recalled this, nor has the Examiner identified any documentary support for it.

Compensation Committee members, however, suggest that prior to approving the Program, the Compensation Committee received any information about the terms of the Program or about how Management intended to administer the Program. Despite these informational deficiencies, the Compensation Committee approved a Program that: (a) granted stock options to unspecified employees "as recommended by Mr. Ebbers;" (b) allowed vesting "in two equal installments on July 1, 2001 and July 1, 2002, or as otherwise determined by Mr. Ebbers;" and (c) provided "special cash bonuses" to unspecified employees, with the "individual amounts and recipients of such cash bonuses" to be "determined by Mr. Ebbers."

3. The Execution of the Program

Armed with this vast discretion, Mr. Ebbers proceeded to dispense some $240 million in Company cash upfront and without a written commitment from the recipients. First, despite the fact that several Executives involved in planning the Program had urged Mr. Ebbers to spread out bonus payments over the two-year retention period – July 2000 through July 2002 – Mr. Ebbers insisted that the Company pay all bonuses up front.[109]

Second, over the strong objections of many executives – and of the Company's Legal Department – Mr. Ebbers did not require any bonus recipient to sign a contract requiring the recipient to repay the bonus if he or she left the Company's employ before the end of the 2-year period.[110] Instead, Mr. Ebbers merely presented each bonus recipient with a letter explaining the purpose of the bonus and requesting a personal commitment to abide by its conditions. Many of

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109 Mr. Ebbers had observed this same procedure several years earlier in connection with a retention bonus program that followed one of the Company's significant acquisitions. At the time, however, Mr. Ebbers personally knew every bonus recipient, and there were well under 100 of them. In contrast, some 558 employees received bonuses under the May 2000 Bonus Program and Mr. Ebbers did not know them all personally.

110 At least one Senior Executive tried to convince Mr. Ebbers that the retention bonuses should take the form of a forgivable loan, with accompanying loan documentation, such that any employee who departed before the end of two years would have to repay the "loan."

these amounts were extremely generous, including 17 individual awards of $1 million or more to individual employees, other than Messrs. Ebbers and Sullivan.

Perhaps not surprisingly, the Company has been forced to sue several bonus recipients who quit WorldCom before July 2002. It has chosen, however, not to seek recovery from certain employees who were either fired or laid off due to a "reduction in force."

4. Corporate Governance Issues in the Retention Bonus Program

The structure and implementation of the May 2000 Retention Bonus Program points to a number of serious weaknesses in the Company's compensation decision-making process. First, the Program's promoters failed to collect or to review any objective information about the need for such a program or about the type of program that would best ensure the retention of truly key employees.

Second, the Compensation Committee appears to have ignored its publicly-stated role in monitoring such compensation by effectively rubber-stamping a program of enormous financial scope without obtaining sufficient detail to pass any rational judgment on that program.

Third, Mr. Ebbers enjoyed unfettered discretion to dictate the scope and terms of the Program, and he rejected advice from those who had qualms about the implications of its structure, including up-front payments and no written repayment commitment.

5. May 2000 Senior Executive Retention Bonuses

a. The Compensation Committee Process

Not only did Mr. Ebbers dispense $240 million in cash retention bonuses in mid-2000, he and Mr. Sullivan also received $10 million bonuses that same year. At the same time that the May 2000 Retention Bonus Program was underway, the Compensation Committee authorized retention bonuses for Messrs. Ebbers and Sullivan, conditioned on their agreement to stay with the Company for a period of two years. No specific plan or grant of authority governed the disbursement of these retention bonuses, and there is a dispute among Compensation Committee members as to how these bonuses even came about.

According to one former Compensation Committee member, the desire to retain Mr. Sullivan drove the Committee's actions. As this former member recalls, the Compensation Committee had two reasons for making this extraordinary grant to Mr. Sullivan. First, the Compensation Committee believed that Mr. Sullivan was an able CFO who provided tremendous value to the Company. Second, the Compensation Committee believed that Messrs. Sullivan and Ebbers had a strained relationship and that Mr. Sullivan needed additional incentives to remain at the Company.

The bonus for Mr. Ebbers, on the other hand, was not motivated by any perceived need to retain Mr. Ebbers. Rather, the Compensation Committee simply concluded that it would not be politically palatable to award a retention bonus to Mr. Sullivan and not to Mr. Ebbers.[111]

No matter how the bonus originated, former Compensation Committee members agree that the Committee offered Messrs. Ebbers and Sullivan several alternatives for the retention bonus, including cash, a stock option grant or some form of future retirement package, all with the same nominal value of $10 million. When the Compensation Committee presented these options to Mr. Ebbers, he told the Compensation Committee that he would consult with Mr. Sullivan and get back to them.

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[111] According to a former Compensation Committee member, Mr. Ebbers was so invested in the Company that the Committee believed "he probably wasn't going anywhere." Nonetheless, the Compensation Committee felt that it would not be politically possible to give Mr. Sullivan a retention bonus without also giving one to Mr. Ebbers. If this was in fact the Compensation Committee's rationale, it was prescient indeed. In 2001, when the Compensation Committee awarded Mr. Sullivan a performance bonus, Mr. Ebbers refused to pay it, because he himself had not received one from the Committee.

Months later, Mr. Ebbers reported back to the Committee that both he and Mr. Sullivan would prefer the $10 million in cash. The Compensation Committee apparently acceded to this request without any further discussion, despite that every other retention bonus recipient had received a combination of cash and options and that the Compensation Committee's theory of executive compensation was to align the interests of the Executives with the interests of the shareholders by awarding stock options as a substantial portion of compensation. Moreover, as noted above, Mr. Ebbers received the $10 million cash bonus at the same time that he received his first loan from the Company in the amount of $50 million.

The Compensation Committee authorized these $10 million cash payments only one year after giving retention bonuses of $7.5 million and $1.85 million to Mr. Ebbers and Mr. Sullivan, respectively. The Examiner is not aware of any evidence that Mr. Ebbers needed a retention bonus to keep him at the very Company that he built or that there was a significant risk that Mr. Sullivan would leave WorldCom.

b. Mr. Sullivan's Payments to Others

After Mr. Sullivan received his $10 million cash bonus, he shared a portion of this bonus with some of his subordinates, many of whom already had received sizeable retention bonuses themselves (as much as $795,000). Preliminary information suggests that at least seven of Mr. Sullivan's closest subordinates received personal checks in the amount of $10,000 from Mr. Sullivan. Mr. Sullivan also wrote $10,000 personal checks to the spouses of certain of these seven subordinates, Although the Examiner has not identified any evidence linking these payments to illegal conduct, four of the individuals who received these payments pled guilty to accounting fraud.

IX. ACCOUNTING AND RELATED INTERNAL CONTROLS

WorldCom's June 25 and August 8, 2002 announcements that its restatement would impact EBITDA by a magnitude of $7.1 billion due to the discovery of fraudulent accounting practices rocked the very foundations of the Company and caused tremors felt throughout international financial markets. A fraud of such magnitude did not occur in a vacuum. Key systems and layers of the Company's oversight and internal controls failed to detect some of the problems until June 2002. Even then, a portion of the fraud was detected due to a confluence of events, rather than as a result of any systemized audit procedures.

In connection with these matters, the Examiner and his professionals have reviewed thousands of pages of documents and have conducted or participated in numerous interviews of the former Directors and members of the Board's Audit Committee; the Director and key personnel in the Internal Audit Department; certain members of the senior financial management team in place at the Company when the fraud occurred; and as well as various current and former employees in the Company's financial operations.[112] The Examiner and his professionals have also reviewed work-papers generated by members of the Arthur Andersen engagement team in connection with its audits of WorldCom's financial statements for the period between 1999 through 2001.

In addition, since the announcement of the Company's June and August 2002 restatements, the Company has been engaged in a lengthy investigation of its books and records through an internal Restatement Group as well as a re-audit of its financial statements for the years 1999 through 2001 by its new external auditors, KPMG. The Examiner and his professionals have been reviewing that process to ensure that the Company takes appropriate

[112] As noted above, there are a number of former employees who have not been available for interviews by the Examiner.

measures to identify any material accounting irregularities that have not heretofore been addressed through the two previously announced restatements.

Although the Examiner's investigation in this area is ongoing, the Examiner is able to reach some preliminary conclusions. A discussion of some of these preliminary conclusions is set forth below.

A. The Weaknesses in WorldCom's System of Oversight and Internal Controls Relating to Accounting Policies

Without assessing specific blame and responsibility for the accounting improprieties, WorldCom's system of oversight and controls over the Company's accounting policies cannot be completely absolved of its responsibility in this matter. Even though the improper capitalization of line costs was discovered by the Company's Internal Audit Department and, upon discovery, properly addressed by the Company's Audit Committee and successor external auditors, the weaknesses inherent in WorldCom's system of oversight and internal controls created an environment where such improper accounting practices could be formulated and carried out without detection for years.

Like most public companies, WorldCom had several layers of oversight and internal controls that, had they been effectively designed and had they worked properly, should have, at minimum, allowed the detection of the fraud an earlier point. In addition to certain basic internal controls, the Company had three separate bodies charged with the responsibility of overseeing the Company's accounting practices and protecting the interests of the Company and its shareholders: (i) the Audit Committee; (ii) the Internal Audit Department; and (iii) Arthur Andersen, the Company's external auditors during the period at issue.

The members of the Audit Committee and the Internal Audit Department personnel appear to have taken their jobs seriously and worked to fulfill their responsibilities within certain limits. It is important to note that once Internal Audit personnel identified suspicious accounting entries as part of their 2002 audit of the Company's capital expenditures, they acted appropriately to report their suspicions to Mr. Bobbitt, the Chairman of the Audit Committee who, in turn, involved the Company's new external auditors, KPMG. At that point, Internal Audit, the Audit Committee and KPMG properly pursued this matter and took steps to investigate and determine whether the entries were improper, identify those involved and adopt corrective measures.

Taking all that into consideration, the Examiner observed a number of deficiencies in the operations of the Audit Committee and Internal Audit. The Examiner has not completed his investigation of the conduct of Arthur Andersen and thus is not able to reach conclusions. However, based on the documents and information reviewed to date, as well as interviews of WorldCom personnel who interacted with Arthur Andersen, the Examiner is troubled by certain aspects of Arthur Andersen's relationship with the Company, especially in the conduct of its annual audits.

B. The Audit Committee

1. The Committee's Composition and Mission

During most of the relevant period, the Audit Committee was made up of its Chairman, Max Bobbitt, and members Carl Aycock, Francesco Galesi, and Judith Areen. Mr. Allen replaced Carl Aycock in May 1999. Mr. Bobbitt served as Chairman of the Audit Committee from about 1994 until December 2002 when he resigned from the Board. Messrs. Bobbitt, Aycock and Allen each had financial expertise, and Messrs. Allen and Bobbitt had started their careers as auditors for Arthur Andersen. In addition, both Messrs. Allen and Bobbitt had served as chief financial officers of various companies and developed backgrounds in the telecommunications business. Mr. Aycock had served in various accounting-related capacities at other public companies, including as a controller. Neither Ms. Areen, a lawyer and the Dean of Georgetown University Law Center, nor Mr. Galesi, a real estate businessman, had any formal financial background.

In the fall of 1999, in response to the release of the report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, the WorldCom Audit Committee performed a review of its mission and responsibilities, with the assistance of in-house counsel and Arthur Andersen. The Audit Committee approved a formal Charter setting forth its responsibilities. The Charter was publicly disclosed to the shareholders as part of the Company's proxy statements.[113]

As stated in its Charter, the Audit Committee's primary function was to assist the Board of Directors in fulfilling its oversight responsibilities to shareholders, potential shareholders and the investment community relating to the Company's system of internal controls, corporate accounting, financial reporting, legal compliance and ethics. In accordance with its Charter, the Audit Committee committed to: (i) serving as an independent and objective party to monitor the Company's financial reporting processes and internal control systems; (ii) reviewing and appraising the audit efforts of the Company's independent accountants and internal auditing department; and (iii) providing an "open" avenue of communication among the independent accountants, financial and senior management, the Internal Audit Department and the Board of Directors.

Under the terms of the Charter, the Audit Committee was to be made up of three or more independent directors who would be "free from any relationship that, in the opinion of the

[113] The Audit Committee reviewed and revised its Charter once in February 2001, adding a provision relating to their requisite review of non-audit services provided by external auditors in connection with their consideration of the independence of WorldCom's external auditors.

Board, would interfere with the exercise of his or her independent judgment as a member of the Committee." Importantly, the Charter charged all members with being familiar with basic finance and accounting practices, including the ability to read and understand fundamental financial statements, and required at least one of the members to have accounting or related financial management expertise.

The Committee committed to meeting as a group at least three times annually, as well as to annual meetings with Management, the Vice President of Internal Audit, and the external auditors in separate executive sessions to discuss any matters that the Committee or any of these groups believed should be discussed privately. Last, the Committee or, at least its Chair, was to meet with the independent accountants and Management of the Company quarterly to review the Company's financial statements.

2. The Audit Committee's Performance

The Audit Committee appears to have conducted its business in a way that, on the surface, met the requirements of its Charter, with its members appearing to have acted in good faith to carry out the letter of their responsibilities to the Company and to its shareholders. Several of its members had financial expertise including backgrounds in auditing, and/or in key financial positions in other public companies, though none otherwise served at the level of a company such as WorldCom. Certainly, there was sufficient financial expertise at the Committee levels, and most of its members understood issues relevant to the Company's financial operations. As the Company's accounting systems grew through acquisitions, the complexity of the systems and the lack of integration between the various accounting systems made oversight by the Audit Committee difficult.

The Committee members met three to five times per year, usually immediately prior to the quarterly meetings of the Board of Directors. While the agenda for the meetings was set by the Chairman, input for the agenda was also provided by the CFO, the Director of Internal Audit and the external auditors. The Director of Internal Audit was responsible for preparing information packages for the Committee members and disseminating those packages in advance of each meeting. Generally, the meetings would include presentations from the CFO (with rare participation by other members of the senior financial management team), the Director of Internal Audit and periodically members of her staff, and the key engagement personnel from Arthur Andersen. The CFO appears to have determined whether the Internal Audit Director would be asked to present at particular Audit Committee meetings. It is unclear whether the members of the Audit Committee were aware of Mr. Sullivan's role in determining the timing of presentations by Internal Audit. The Audit Committee meetings were fairly short and focused primarily on the presentations made by the CFO, Arthur Andersen and/or Internal Audit.

While the Audit Committee performed its ministerial functions, there are a number of aspects of that performance that are troubling from a corporate governance standpoint. Overall, despite good faith efforts to fulfill its responsibilities and the active engagement of the Chairman, the Committee rarely scratched below the surface of issues that arose. The strong control and influence exerted by Management over Internal Audit and Arthur Andersen, and the weakness of the reporting mechanisms between the Committee, Internal Audit and Arthur Andersen, reduced the role of the Committee to that of an overseer, taking at face value the representations of Management, the external auditors and, at times, Internal Audit. Few issues of concern were expressed to the Committee, and no alarming issues respecting the Company's financial operations and statements arose throughout the years.

Although the Audit Committee acted properly once it became aware of accounting improprieties, there are certain structural weaknesses that fostered an environment at the

Company that allowed the fraud to go undetected. Further, certain opportunities to make the reporting to the Committee by Internal Audit and Arthur Andersen more meaningful and to remove the influence of Management over those two very important functions were lost.

First, while most members of the Audit Committee perceived the Internal Audit Department as reporting to the Audit Committee, that was not the case, functionally or practically. At its inception in or about 1993, the Internal Audit Department and its Director reported to the Vice President of Financial Operations who, in turn, reported to the CFO at the time, Mr. Cannada. Mr. Cannada was responsible for the establishment of an Internal Audit Department and the recruitment of its Director. After a difficult beginning, Mr. Cannada and the Audit Committee modified the reporting relationship so that the Internal Audit Director reported to Mr. Cannada directly. Internal Audit continued to report to Mr. Cannada, even after he had been replaced as CFO by Mr. Sullivan in 1994, and he assumed the new position of Director of Corporate Development until his departure in February 2000. At that time, the Internal Audit Department began to report to Mr. Sullivan directly.

The Company's organizational charts reflect that, by at least May 1997, Internal Audit also had a "dotted line" reporting relationship with the Audit Committee that, by March 1999, had evolved into a solid line dual reporting relationship to both Mr. Cannada, and later, Mr. Sullivan, and the Audit Committee. Throughout this entire period, however, Mr. Cannada or Mr. Sullivan was responsible for reviewing Internal Audit's annual and revised audit plans and assigning additional non-audit and audit-related projects to Internal Audit. Mr. Cannada or Mr. Sullivan and/or Mr. Ebbers, as well as affected Management, reviewed preliminary audit reports issued by Internal Audit, and made comments and recommended changes. Importantly, Mr. Cannada or Mr. Sullivan, working in conjunction with Mr. Ebbers, determined and controlled Internal Audit's budgets, staffing, compensation and bonuses. Indeed, as stated above, Mr. Sullivan even appeared to determine at times whether the Internal Audit Director would have an opportunity to address the Audit Committee at meetings.

The Audit Committee, as part of its responsibilities, annually reviewed and approved Internal Audit's audit plan. The Audit Committee did not have any input into changes that were made to the annual audit plan by Internal Audit as the audit year evolved, though the Committee may have been advised periodically of some of those changes after the fact. Internal Audit presented to the Audit Committee its final recommendations at the conclusion of its audits. Generally, the Audit Committee received only executive summaries of the final audit reports and, rarely, the final audit reports in their entirety. While some discussion about Internal Audit's inadequate resources and budgets appears to have occurred at Committee meetings, the actual decisions were made at the level of the CFO and CEO. For example, the Audit Committee had no role in approving the use by Mr. Ebbers of Internal Audit Department personnel and resources to compile a time-consuming, non-audit related monthly operations report called the Executive Reporting Package ("ERP").[114]

Moreover, members of the Audit Committee apparently operated under a number of ill-founded presumptions about Internal Audit, including that Internal Audit coordinated its audits with Arthur Andersen and that Arthur Andersen was provided with copies of all final reports prepared by Internal Audit. The members of the Audit Committee also appear to have presumed that, even though Internal Audit identified internal control weaknesses in its final reports, those

[114] Some Audit Committee members indicated that they were not even aware of Internal Audit's involvement in the ERP or, at least the large commitment of its resources until March 2002, when the CFO informed the Committee that responsibility for the ERP would be transferred to another department in order to soften the impact of Company-wide budget cuts on Internal Audit. Mr. Sullivan informed the Audit Committee that the CEO had wanted to slash Internal Audit's budget by 50 percent but that he had been dissuaded.

weaknesses were not material since Arthur Andersen would always report that it had not found any material internal control weaknesses in connection with its own audits. Yet, no one appears even to have attempted to confirm that Internal Audit and Arthur Andersen were communicating about such issues or analyzing the materiality of the weaknesses identified by Internal Audit. Further, while the Audit Committee did meet with the Director of Internal Audit in executive sessions, the frequency of those meetings is debatable. The minutes of the Audit Committee meetings prepared by the Internal Audit Department do not reflect any executive sessions with the Internal Audit Director from 1999 until March 2002. Regardless, the members of the Audit Committee and the Internal Audit Director confirmed that no problematic issues appear to have been brought to the attention of the Audit Committee by Internal Audit during any of these sessions or otherwise, prior to March 2002. Given the nature of the true reporting relationship between Internal Audit and the CFO and CEO, it is highly unlikely that any issues of concern could have been raised by the Internal Audit Director with the Audit Committee without a negative reaction from the CFO or CEO.[115]

Second, the Audit Committee appears to have missed a meaningful opportunity in its communications with Arthur Andersen when it did not require the preparation and presentation by Arthur Andersen of annual Management comment letters to the Committee. The management comment letter is a reporting tool by which the external auditors identify and report to the Company's Audit Committee issues of concern encountered in the course of their annual audits, together with recommendations for corrective action. Normally, Management is provided with a copy of the Management comment letter and given the opportunity to prepare responses to the

[115] As noted, once Internal Audit identified the suspicious line cost journal entries and their origin, the Internal Audit Director did contact the Chairman of the Audit Committee directly. However, that appears to have been a rare, though laudable, exception in the working relationship with the Committee.

issues raised by the external auditors. Those Management responses are also provided to the Audit Committee.

Through at least the 1996 audit, Arthur Andersen prepared and presented to the Audit Committee Management comment letters identifying its concerns and recommendations for corrective action. For example, in a 1997 draft Management comment letter prepared by Arthur Andersen in connection with its audit for the year ended December 31, 1996, Arthur Andersen advised the Audit Committee, among other things, of the need for strengthening the Company's internal controls as the Company was growing through acquisitions, bolstering the Internal Audit Department, and instituting fraud training for the Company's senior Management.[116]

However, this is the last such letter that the Examiner has been able to obtain. There is no evidence that any such letters were prepared and presented to the Audit Committee from 1998 through 2001, nor did the Audit Committee appear to have received a deficiency letter sent by a foreign subsidiary of Arthur Andersen to the Company's Management in the United Kingdom. No one could explain why this commonly accepted practice of providing to the Audit Committee Management comment letters ceased, and it does not appear that any member of the Audit Committee even remarked about not getting such reports. The Examiner also has not been able to identify any reporting mechanism to the Audit Committee that was substituted in its place. Accordingly, there does not appear to have been any meaningful reporting mechanism used by Arthur Andersen to report to the Committee on internal control weaknesses or deficiencies beyond the quarterly "canned" presentations it made to the members of the Audit Committee,

[116] The Examiner has not been able to obtain Management's responses to those recommendations to date or any information as to what steps, if any, were taken by the Company to address the concerns raised by Arthur Andersen.

and the pre-earnings discussions held between Arthur Andersen, the Chairman of the Audit Committee and the CFO.

Third, the Audit Committee appears to have placed enormous confidence in Mr. Sullivan, the Internal Audit Director and Arthur Andersen. Our investigation suggests that the Committee fully relied on their representations without much detailed inquiry. The oral feedback to the Committee received from each of these parties appears to have been positive. It was not until March 2002 that any tensions between Internal Audit and Management became apparent to the members of the Committee, even though such tensions existed throughout the history of the Internal Audit Department. It was not until Ms. Cooper contacted Mr. Bobbitt on June 12, 2002 to inform him about the discovery of certain journal entries that appeared problematic, that there was any indication to the Committee of any wrongdoing, or indeed, any reason to probe. No one thought to bring any concerns relating to the improper accounting practices to the attention of any member of the Audit Committee while the practices were occurring. The Audit Committee, though well-meaning, was by its own nature too distant a player in this drama.

Fourth, the Examiner is also troubled by certain practices by the Audit Committee from a corporate governance standpoint. While none of these practices have any bearing on the fraud, they speak to the informality associated with the operations of the Audit Committee, which failed to address the needs of a public company of the size and complexity of WorldCom. For most of the relevant period, the Audit Committee did not conduct its business with the benefit of any advice of counsel, including in-house counsel, except for particular limited projects, such as in connection with the drafting and revisions of its Charter. Until the spring of 2002, in-house counsel did not participate in any of the meetings, including any executive sessions, and played no role in the drafting of the Minutes for the Committee. It was not until after the disclosure of the problems at Enron, and the related criminal indictment of Arthur Andersen, that any suggestion was made by members of the Committee to retain outside counsel.

Fifth, there was no review at the Committee level of membership criteria and independence qualifications. For example, even though a Nominating Committee existed at the Company, it had little or no involvement in the nominations of persons to serve on the Audit Committee. Members typically were added to the Audit Committee at the request of Mr. Ebbers. The Committee also did not have any process to ensure that members were and remained qualified and independent to serve on the Committee, even though its Charter provided for some basic qualifications, including independence and financial expertise on the part of some of the members. There was no effort at the Committee level to assess systematically the continuing independence of each member, including the review of the stock ownership of each member, and to ensure that any potential conflicts were identified and properly addressed. While each Committee member recalls periodically completing and submitting to in-house counsel or the Director of Financial Reporting, standard "D&O" questionnaires identifying their professional relationships, it is unclear whether any meaningful review of those questionnaires was performed by anyone at the Company level. Certainly, no review was performed at the Committee level.

Sixth, there were serious deficiencies in the drafting and maintenance of Minutes memorializing the deliberations of the Audit Committee. Prior to February 2002, the Minutes provided only brief, boiler-plate summaries of the Committee's deliberations with a number of discrepancies and omissions on such important matters as: (i) whether and how often the Committee met in separate executive sessions with the external auditors and with the Director of Internal Audit; (ii) the substance of any discussions by Arthur Andersen or Internal Audit regarding the specific results of their audits; and (iii) whether the retention of Arthur Andersen as the Company's independent auditors was formally approved by the Committee annually. There are no Minutes for any of the executive sessions and no person we interviewed had any specific memory of issues discussed during those sessions. The Director of Internal Audit was tasked with preparing the Committee's Minutes after each meeting, but that task was often delegated to personnel within the Internal Audit Department who may or may not have attended the meetings, and who, on at least one occasion, solicited feedback about what happened in the meeting from Arthur Andersen personnel who had attended. The final Minutes appear to have been circulated, but few, if any, members of the Committee actually reviewed them, other than the Chairman who signed them. Thus, the reliability of the Minutes of meetings of the Audit Committee is highly suspect.

C. Internal Audit

1. Its Mission and Scope

WorldCom's Internal Audit Department was initiated in about 1993 at the suggestion of the Company's then-CFO, Mr. Cannada, in order to develop a system of oversight of the Company's operational and financial internal controls. Shortly thereafter, Mr. Cannada recruited Cynthia Cooper, a former auditor in SkyTel's Internal Audit Department, to lead the small department. The mission, size and scope of the Internal Audit Department evolved as the Company grew and, despite budget difficulties and recruiting and retention challenges, Ms. Cooper was able to hire professionals who appear to have been dedicated to fulfilling the duties and responsibilities of the Department. However, throughout the years, while the decision to form an Internal Audit Department had been made, the complete acceptance of that Internal Audit Department by WorldCom's senior Management was an entirely different matter.

It is now clear that the Internal Audit Department, despite some dual reporting responsibility to the Company's Audit Committee, was never truly an independent department but rather reported and was answerable to senior Management including the CFO, or Mr. Cannada, and the CEO. Members of the Internal Audit Department did not believe that Mr. Ebbers initially accepted the necessity of an Internal Audit Department at his Company and claim that he had to be convinced of its value. The viability of the Internal Audit Department was thus largely dependent on the whim of senior Management, and especially the CFO and CEO, with little more than deference being given to the Audit Committee. For years, the leadership of the Internal Audit Department sought to gain acceptance as team players by focusing the work of the Department on audits and projects that would be seen as adding "value" to the Company, rather than fulfilling any role as the Company's "internal control police."

Internal Audit focused primarily on finding ways to assist the Company in maximizing revenue, reducing costs and improving efficiencies. As a result, most of the audits conducted by Internal Audit were strictly operational audits with these objectives in mind. Over the years, Internal Audit did conduct some operational audits with financial components. However, we could not discern any methodology used to determine those operational audits that would also include a financial component.

While Internal Audit reviewed the relevant financial amounts generated in the detail subsidiary journals, it did not, for the most part, trace transactions to the general ledger. Internal Audit personnel and members of the Audit Committee appear to have assumed that Arthur Andersen would be reviewing the flow of transactions through to the general ledger and externally reported levels and wanted to avoid duplication of that work by Internal Audit. Many of the audits performed resulted in findings that were relevant to the Company's revenue recognition policies. Yet, there did not appear to be any meaningful coordination, especially in recent years, between Internal Audit and Arthur Andersen to ensure that Internal Audit's findings were not material to the Company's financial statements and revenue recognition policies.

In this way, Internal Audit focused its audits primarily on areas expected to yield cost savings and additional revenues. Examples of such areas included audits of the payment of commissions to the sales force, the classification of customer credits, the processing of local orders and calls, the review of pricing relationships with vendors, the adoption and integration of new information technology initiatives by various units of the Company, and various matters relating to the Company's capital expenditures.

Both the Audit Committee and Arthur Andersen were aware of the narrow operational scope of Internal Audit's work. It has been noted by many witnesses that Ms. Cooper and her department gradually obtained acceptance within the Company as they were able to show quantifiable results from their audits, such as the reductions in costs or the identification of revenues that were being overlooked. At times, those achievements earned praise for the Internal Audit Department from senior Management, including Mr. Ebbers and Mr. Sullivan.

The concept of an operationally-focused Internal Audit Department might have been acceptable for a company the size of WorldCom, had there been active coordination and communication between Internal Audit and the Company's external auditors to ensure that any significant financial issues encountered by Internal Audit in the course of its operationally-focused audits were indeed reviewed and properly addressed by the external auditors. However, that was not the case, especially in the last five to six years. There is very little evidence of any meaningful communication between Arthur Andersen and Internal Audit during the relevant time period. Indeed, Arthur Andersen made it clear that it did not rely on the work performed by Internal Audit in the context of its own audits. While there are some limited examples of

Internal Audit referring matters to Arthur Andersen for its review, and while Arthur Andersen appears to have received copies of some final audit reports, or at least summaries presented at the Audit Committee meetings, generally, Internal Audit and Arthur Andersen were two ships passing in the night.

Internal Audit's narrow focus may have contributed, in part, to the Company's failure to detect some of the accounting improprieties reported by WorldCom at an earlier stage. Even though a line cost audit appears to have been annually scheduled by the Internal Audit Department, it was always the first to be rescheduled due to other priorities. When it performed the line cost audits, Internal Audit focused on the operational level without apparently any review or verification of the Company's general ledger and the journal entries that supported those line costs.

In the fall of 2001, Internal Audit was engaged in an audit of the Company's systems and controls relating to capital expenditures. At the time, certain operations personnel were concerned about a number of unexplained and large discrepancies between the amount of capital expenditures tracked internally by the Company's operational departments responsible for spending the capital, and the amount of capital expenditures externally reported. It is unclear whether these concerns were brought to the attention of Internal Audit personnel conducting the audit. It is certain, however, that no audit work was designed or performed to review and understand such discrepancies, and to verify that the externally reported numbers were indeed correct. During the course of the audit, Internal Audit personnel became aware of certain categories of "corporate accruals" amounting to about $2.3 billion, but it simply accepted, without verification, the explanations of the financial reporting personnel that the accruals were proper, as well as the descriptive language they supplied as part of its final report issued in January 2002.

Several months later, in late May 2002, after Mr. Ebbers' departure and the replacement of Arthur Andersen by KPMG, Internal Audit initiated a follow-up capital expenditure audit.[117] In a study of contrasts, the 2002 follow-up audit included a financial component with Internal Audit seeking to verify the actual journal entries that supported the corporate accruals they had identified as part of their 2001 audit. Why Internal Audit decided to include a financial component to this particular audit has never been fully explained to the Examiner's satisfaction. However, , it is undisputed that, once Internal Audit reviewed the journal entries at issue, their suspicious nature was apparent in light of the behavior of accounting personnel they interviewed who were aware of such entries. There can be no dispute that once these entries were identified by Internal Audit personnel as suspicious, they acted appropriately to sound the alarm with the Audit Committee Chairman and proceeded to investigate them.

Since Internal Audit was operationally focused, it generally commented on accounting controls when a control weakness had an operational impact. As a result, internal controls with an impact on the Company's accounting policies were not systematically evaluated and monitored by Internal Audit and certainly were not communicated to the external auditors for their review. This is a serious weakness in the internal control evaluation process, which was not questioned by Internal Audit, Arthur Andersen or the Audit Committee. It was clearly inappropriate for a company as large and complex as WorldCom to have its Internal Audit Department focused on operations or operational auditing. Absent diligent attention by the Internal Audit Department to financial control systems, and in light of the risk-based audits

[117] The Examiner has obtained conflicting statements as to the reasons why a follow-up audit was initiated by Internal Audit so soon after finalizing its 2001 audit in January 2002.

performed by Arthur Andersen, the probability of financial statement fraud was high due to the complexity and dispersed nature of the Company's organization and financial operations.

2. Management's Influence Over Internal Audit

As stated above, for most of the relevant period, the Internal Audit Department functionally reported to the Company's CFO but formally had a dual reporting relationship to both the CFO (or, for a time, to Mr. Cannada), and to the Audit Committee. The CFO oversaw all personnel actions for the Department, approving promotions and changes in officer titles, as well as salary increases, bonuses, and stock options, and provided guidance to the development of the scope of the Department's audits and audit plans, the conduct of its audits, and the issuance of its conclusions and recommendations. The Audit Committee approved the charter for the Internal Audit Department in November 1999 and annually approved audit plans but, in contrast to the CFO or to Mr. Cannada, had little to no input regarding the modification of those plans during the audit year. Internal Audit presented to the Audit Committee its final conclusions and recommendations developed in cooperation with Management, in the form of summaries and oral presentations and, occasionally, final reports. The Audit Committee had no input in either the development of the scope of each audit or the findings and recommendations issued at its conclusion. Nor did the Audit Committee play any role in determining the day-to-day activities of the Internal Audit department.

At times, Mr. Ebbers or Mr. Sullivan would assign "special projects" to the Internal Audit Department. Some of these projects were not audit-related and the Audit Committee does not appear to have been consulted about such assignments. In a glaring and disturbing example, in the fall of 2000, Mr. Ebbers assigned to the Internal Audit Department responsibility for generating the ERP, which was a compilation of schedules and trend analyses for tracking orders, activations, disconnections and cancellations received by the Company from its customers each month, and estimating the Company's revenues associated with those orders. This reporting package was purely operational in nature and had no audit purpose or use, but enabled senior Management, and Mr. Ebbers in particular, to track on a monthly basis increases or decreases in orders placed with the Company by its customers and potential swings in revenue associated with those orders.

The production of the ERP was time-intensive, consuming most of the time of Internal Audit's staff for at least the first six months of its inception. This effort drained scarce departmental resources and delayed scheduled audits. Internal Audit staff have indicated that, at times, they would work on the ERP during the day and stay late into the evening to perform the audit functions they were unable to perform during the day. The use of Internal Audit for the ERP was reportedly defended by Ms. Cooper to a complaining staff member as an important effort that added "value" to the Company, was in keeping with her department's consulting function within the Company, and could demonstrate to the Company's leadership the indispensability of the Internal Audit Department. Over time, the amount of time and resources spent by Internal Audit on the ERP decreased to a group of three to four staff members until Mr. Sullivan transferred responsibility for the ERP in March 2002 to the Chief Operating Officer's staff to soften the blow of Company-wide budget and staffing cuts on Internal Audit. It is disturbing that, despite such a heavy commitment of time and resources by Internal Audit to a non-audit related effort, the Audit Committee does not appear to have ever been consulted about this assignment or informed of its impact on the Department's scarce resources until the decision was made to transfer responsibilities for preparation of the ERP to a different department nearly two years later. Significantly, Internal Audit did not meet its audit plan objectives, in part, because of the time and resources devoted to the ERP.

Other instances of projects assigned by Management to Internal Audit abound, though some projects, such as Mr. Ebbers' involvement of Internal Audit in an audit of possible commissions fraud by salespersons, were an appropriate use of Internal Audit. In one telling incident, Mr. Sullivan involved Internal Audit personnel in assisting him to obtain information about certain overseas WorldCom employees whose employment he was considering terminating. Apparently, Mr. Sullivan directed that the internal auditor contact the appropriate human resource department and represent that he was conducting an internal audit in order to obtain copies of the relevant employment contracts. The reporting relationship of Internal Audit to the CFO, coupled with the influence of the CFO and the CEO over a number of areas detailed below, appear to belie the notion that Internal Audit acted independently of the Company's Management, at the direction of the Audit Committee.

3. The Lack of Budgetary Resources Seriously Impacted Internal Audit

While Internal Audit grew and evolved as a department as the Company grew, the resources accorded to Internal Audit were insufficient, especially in comparison to other internal audit departments at peer telecommunications companies. According to the 2002 Global Auditing Information Network peer study ("Gain Study") conducted by The Institute of Internal Auditors ("IIA"), WorldCom's Internal Audit Department, at a staff of 27 by 2002, was half the size of the internal audit departments of peer telecommunications companies. In May 2002, after Mr. Ebbers' departure from the Company, Ms. Cooper presented the results of the Gain Study to the Audit Committee, advising them that her Department was understaffed and underpaid. The minutes reflect that she advised the Committee that the average cost of each of their internal auditors was $87,000 annually, well below the peer group average of $161,000. Yet, the Audit Committee members apparently did not perceive Ms. Cooper as making any request for additional resources at that time and pointed out that she emphasized that her Department's lack of resources was offset by the caliber of the department personnel. In any event, prior to this point, there are few indications that the Audit Committee was made aware of any budgetary constraints on Internal Audit or that, once made aware, they had any impact on requests to increase staff and resources.

As the Company's finances became troubled, Internal Audit's resources were impacted significantly. While salaries for Internal Audit auditors were not generally competitive, the Company also faced recruiting and retention challenges that were unique to a location that was not metropolitan. Moreover, the restrictions on travel imposed due to budget constraints made managing and conducting audits of Company units located outside of Clinton, Mississippi, and particularly, international audits even more difficult because most of the international audit staff and the international audit director were located in Mississippi, together with a small staff in Florida. An Internal Audit function operating with such limited resources appears particularly inappropriate from an internal controls perspective given the international breadth and scope of the Company's operations and the challenges posed by the Company's status as a conglomeration of recently merged or acquired companies. Given these constraints, however, it should be noted that Ms. Cooper was able to build a Department composed of staff holding numerous certifications and degrees who appear to have taken their jobs seriously and worked professionally to fulfill their responsibilities to the Company.

4. The Lack of Any Substantive Interaction with External Auditors

As noted earlier, after 1997, Internal Audit had few substantive interactions with the Company's external auditors other than at the quarterly meetings of the Audit Committee where both made presentations. This is troubling on several levels. Significantly, Internal Audit would identify a number of seemingly important internal control weaknesses as part of its operational audits that impacted financial systems and reporting of revenue. Yet, there does not appear to have been any coordination with the external auditors to ensure that those internal control weaknesses did not rise to the level of materiality. Accordingly, Arthur Andersen's annual statement to the Audit Committee that it noted no material internal control weaknesses as part of its annual audit of the Company's financial statements is quite puzzling, especially in light of the numerous serious internal control weaknesses identified by Internal Audit in its reports and the lack of any analysis by either Internal Audit or Arthur Andersen to confirm that those weaknesses were indeed not material, and had been corrected.

5. Deficiencies in the Annual Internal Audit Planning Process

The determination of Internal Audit's annual audit plan was the product of a number of factors. Ms. Cooper would assess potential audit areas on the basis of perceived risk and give primary emphasis to audit areas that might lead to the detection of significant cost savings or unrealized revenues. In addition, Ms. Cooper received recommendations from her staff and input from the Company's senior Management and the CFO through annual surveys.

The risk assessment employed by Ms. Cooper in connection with the audit plan did not involve the use of quantitative factors to measure risk with respect to internal control weaknesses or prior audit findings. In sum, an audit area's level of risk was determined by assessing whether the audit would add value to the Company and enhance revenue. If it did not meet these criteria, the audit would be considered to have a low level of risk and would not be performed. No quantifiable risk assessment of the weakness or strength of the Company's internal controls was conducted in connection with the planning of the annual audits.

Ms. Cooper's practice was to furnish a draft audit plan to Mr. Sullivan for his review and comments. It is unclear whether Mr. Sullivan actually suggested any changes to the plan at that stage. The plan was then annually presented by Ms. Cooper to the Audit Committee for its review and approval. Few, if any, changes were made at the Audit Committee level and the

Audit Committee was only periodically advised of any changes or delays in the plan following its approval.

The annual internal audit planning process was wholly deficient for a number of reasons. Typically, an annual audit planning process should start with the review of a company's audit universe, which is a risk-rated, comprehensive list of all auditable areas within a company. Risks should be assessed based on the perceived strengths and weaknesses of the internal controls, the security over systems, and the reliability of the personnel responsible for such controls and systems. At WorldCom, risk analysis was instead performed with the goal of selecting audits that could add "value" to the Company by emphasizing revenue enhancements and cost reductions. Moreover, the lack of any consultation with Arthur Andersen resulted in gaps in audit coverage. Given the absence of a comprehensive risk-based internal audit plan, there was no apparent relationship between the audits scheduled annually and the risk and the effectiveness of internal controls associated with these audit areas.

Of concern is the lack of any effective participation by the Audit Committee in reviewing the adequacy of the annual internal audit plan, with the Audit Committee appearing to have approved the final plan as a formality. Based upon requests of Management, other audits, not part of the Audit Committee-approved plan, were added while some audits originally scheduled were not completed. At most, the Audit Committee was advised of such changes after the fact. Under such circumstances, senior Management could influence the focus of the Internal Audit Department away from sensitive areas without the oversight that the Audit Committee would normally be expected to provide.

6. Deficiencies in the Conduct of Internal Audits and the Completion of Audit Reports

All in all, given scarce resources and various external pressures, the personnel in Internal Audit appear to have performed their responsibilities diligently in connection with their assigned audits. Members of the Examiner's team have reviewed most of the final reports prepared by Internal Audit during the period between 1999 through 2002.[118] It is important to note that most of the audit reports we reviewed identified either internal control weaknesses, or even, at times, the complete lack of internal operational controls in particular units. Also, many reports highlighted control weaknesses that had been identified in prior audits but which had not been corrected to the satisfaction of the Internal Audit Department.

The Examiner is troubled, however, by a number of observations that relate primarily to the influence of Management on the conduct and scope of the audits and the preparation of the final reports. First, until January 2002, the Department did not impose in practice uniform internal procedures relating to the conduct of the audits, the preparation and retention of reports and associated work-papers, the compilation and dissemination of Management's responses to recommendations, the conduct of follow-up audits, and steps to be taken to address repeated and serious failures to take corrective action. In January 2002, at the instigation of a number of staff members, the Department revised an Internal Audit policies and procedures manual intended to provide the staff with uniform policies and procedures regarding the manner in which audits were to be conducted, the maintenance of work-papers, the documentation of findings and issues, certification, and continuing education requirements. The Examiner finds it unusual and

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118 However, the Examiner and his team have not performed any actual testing of the conclusions contained in those reports and cannot comment on their methodology or correctness. Representations have been made, as well as disputed, that Internal Audit conducted its audits in accordance with IIA standards and practice advisories.

inexplicable that such uniform policies and procedures would not have been developed and enforced prior to January 2002.[119]

Second, it appears that Management's support of the Internal Audit function was not consistent across the Company. We noted many instances where area management stymied Internal Audit personnel, forcing them to go up the management chain for responses to their requests for information during their audits. Internal Audit personnel would have to make repeated requests for information needed to complete testing and their requests were not always furnished in a timely manner. This is especially apparent in the 2001 Capital Expenditures Audit and its 2002 follow-up.

Third, we noted that Internal Audit's access to the Company's computerized accounting systems was limited. The Internal Audit charter provided that Internal Audit had "full, free and unrestricted access to all company functions, records, property, and personnel." Yet, few Internal Audit staff personnel had full systems access to Essbase, the Company's reporting system, and the Company's general ledgers, and even that access was subsequently limited. It is unclear whether Ms. Cooper ever raised this issue with anyone or took any steps to determine why limits would be placed on her staff's access to the general ledgers.

Fourth, there appears to be unwarranted influence by Management in the preparation of final reports and recommendations by Internal Audit. Internal Audit appears to have conducted its audits in ways that sought to reach agreements with Management about particular recommendations prior to the issuance of a final report. Accordingly, preliminary drafts of the Internal Audit reports were generally distributed to affected Management as well as to Mr. Sullivan and, at times, to Mr. Ebbers. The Audit Committee did not obtain preliminary

[119] We have not yet been able to obtain the 2002 Internal Audit Policies and Procedures Manual and cannot comment at this time on its adequacy or effectiveness.

drafts. All persons on the distribution list could provide to Internal Audit their comments and/or objections to the conclusions and recommendations made in the reports. It is unknown at this time whether Mr. Sullivan and Mr. Ebbers weighed in with any substantive changes to the reports at their preliminary stage. However, we are aware that the language of the final audit reports was the product of many negotiations between the internal auditors, Ms. Cooper and the affected Management.

Fifth, Internal Audit lacked a uniform system of highlighting the seriousness of the internal control weaknesses that had been noted and tracking Management's responses to their recommendations and any corrective steps taken. Sometimes, a response matrix was attached to an audit report identifying the status of Management's actions and comments. However, generally, Management's comments and corrective actions were not always presented to the Audit Committee. Internal Audit appears to have lacked any systematic method for scheduling follow-up audits, or tracking Management's corrective steps, contrary to IIA Standard No. 2500, which states that "the Chief Audit Executive should establish and maintain a system to monitor the disposition of results communicated to management."

7. Changes Since Restatement

We understand that, since the June 2002 Restatement and the adoption of the Sarbanes-Oxley Act of 2002, the Internal Audit Department, under Ms. Cooper's leadership, has instituted initiatives aimed at improving the internal audit function in the Company. We note the following changes:

- **Departmental**. Internal Audit increased its staff by hiring 12 to 15 additional auditors who are licensed CPA's and anticipates adding approximately 10 more auditors. Internal Audit has strengthened training by requiring each professional staff member to obtain 80 hours of continuing professional education annually.

- **Scope of audits**. Internal Audit will perform financial audits in addition to operational audits.

- **Relationship with External Auditors**. An Internal Audit team has been created and tasked with working with KPMG in connection with the audit of the Company's books and records for the years 1999 through 2002. It is anticipated that the external auditors will be able to rely on Internal Audit's work in future audits and will assist Internal Audit in the development of its annual audit plan.

- **Audit Planning Process**. It appears that Internal Audit has developed a comprehensive audit universe and has strengthened risk assessment methodology to include an evaluation of such factors as concerns expressed by external auditors, Management, the Audit Committee, as well as prior audit recommendations, materiality issues, audit frequency, issues associated with the area in the restatement process, and any changes in the area's control and systems processes.

D. The Conduct of the Company's Former External Auditors

The Examiner's investigation into the conduct of Arthur Andersen is ongoing.[120] However, some aspects of Arthur Andersen's relationship with the Company's senior Management, as well as the development and implementation of its audits, appear troubling. Some initial observations of the Examiner are as follows.

1. Arthur Andersen's Planning of the Audit and Assessment of WorldCom's Accounting Risks

Arthur Andersen was initially engaged to audit the financial statements of LDDS, WorldCom's predecessor, and continued as WorldCom's external auditor until April 2002. At that time, WorldCom retained the services of KPMG. The Arthur Andersen engagement team initially included Mr. Cannada, who later accepted employment with WorldCom as its CFO.

At the outset, while WorldCom was a small start-up company, Arthur Andersen performed substantive transaction-based audits of the Company's financial statements and obtained print-outs of general ledger activities upon request. As the Company evolved, however,

120 The Examiner has not had the opportunity to interview any of the former members of Arthur Andersen's engagement team assigned to the audits of WorldCom's financial statements.

Arthur Andersen apparently determined that a full substantive audit would not be feasible and moved to a risk-based model that included a combination of controls testing and substantive tests, where the risks warranted such tests. Such a model is acceptable under Generally Accepted Auditing Standards ("GAAS"), provided the audit plan itself is appropriately designed and implemented.

During the relevant period, Arthur Andersen performed "risk-based" audits of WorldCom's financial statements. In such an audit, the focus is on testing controls and reducing substantive testing if such controls are determined to be effective.

In planning its audits, Arthur Andersen needed to consider, in accordance with U.S. Auditing Standards AU Section 311, a number of factors including:

- Matters relating to WorldCom's business and the industry in which it operated;
- WorldCom's accounting policies and procedures;
- Methods used by WorldCom to process significant accounting information, including the use of service organizations, such as outside service centers;
- Planned assessed level of control risk;
- Preliminary judgments about materiality levels for audit purposes;
- Financial statement items likely to require adjustment;
- Conditions that may require extension or modification of audit tests, such as the risk of material error or fraud or the existence of related party transactions; and,
- The nature of reports expected to be rendered.

In the audit planning stage, Arthur Andersen assessed certain control risks with respect to the design and operating effectiveness of certain applications and defined certain critical processes that required testing, the key risks associated with these processes, and the testing procedures that Arthur Andersen believed were necessary to assess whether the Company had adequate controls to mitigate those risks. Arthur Andersen also set materiality thresholds at five percent of projected income from continuing operations, excluding non-recurring charges. During the audits of the years 1999, 2000, and 2001, the materiality levels were set at $192.2 million, $243.3 million and $175.7 million, respectively. The minimum amount of misstatement for which Arthur Andersen deemed necessary to propose an adjustment was set at about $15 million in 1999, $19.5 million in 2000, and $14.1 million in 2001.

In addition to these quantitative aspects, Arthur Andersen also indicated that it would review a number of qualitative factors to determine whether there were any omissions or misstatements of accounting information that would have a significant impact on the decisions of users of the financial statements. These included trends, the nature of particular adjustments, the impact on liquidity, capital, earnings capacity, the impact to reporting segments, loan covenants and contractual requirements, Management's action plans and any failures to meet the expectations of analysts.

Arthur Andersen also used various tools to assess and document conditions that might require extension or modification of audit tests. Such tools document the risks of error or fraud, Management integrity, complexity of transactions, aggressiveness of the Company's accounting practices, and the existence of related third party transactions.[121]

In evaluating the WorldCom engagement using its SMART tool, Arthur Andersen determined WorldCom to be a maximum risk client in each of the years 1999, 2000 and 2001.[122] Arthur Andersen's overall assessment was based on its analysis of the Company's key risk

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[121] Those tools included the SMART Tool, a Business Risk Model, Expanded Risk Discussion and a Fraud Risk Practice Aid.

[122] Although not required, it does not appear that Arthur Andersen ever communicated this internal assessment to the Audit Committee.

factors related to failure, fraud and error. In addition, Arthur Andersen considered the volatility of the telecommunications industry, the Company's future merger and acquisition plans, and its reliance on a high stock price to fund those acquisitions. Of particular note, Arthur Andersen assessed a "significant" risk of fraud due to the Company's overly aggressive revenue and earnings targets during all three years, and a "fair" risk of failure and/or fraud related to the Company's ability to manage the financial reporting function and commitment to establishing and maintaining a satisfactory internal controls system in 1999. During all three audit years, the Company was assessed a "fair" risk of fraud related to the quality of Management's policies to prevent and detect fraud and certain factors relating to its Management's behavior towards the audit, including whether the Company permitted unrestricted access to information and personnel, or set any unreasonable restrictions, deadlines or disputes respecting the scope of the audit work. Arthur Andersen rated as "very significant" the risk of error by the Company in connection with its selection and application of accounting policies relating to business combination purchase price allocations during 1999, as well as "significant" to "moderate" the risk of error in connection with its accounting and financial reporting during all three years. Such assessments were based, in part, on the significant portion of the financial statements that related to purchase accounting adjustments, including the MCI acquisition, significant investments maintained on the cost and equity basis which, in the past, had resulted in the misapplication of GAAP, as well as WorldCom's utilization of multiple billing systems requiring manual intervention which increased the risk in the billing and collection areas.

Arthur Andersen further evaluated, through a Business Risk Model, WorldCom's risks relating to environment, process, and information for decision-making and noted a number of problems. In particular, the work-papers reflected that Arthur Andersen was aware of two relevant problem areas. In 1999, Arthur Andersen noted a potential for the Company misstating its line costs, expenses and liabilities, and a risk that its Management could manipulate business processes to achieve financial targets. In addition, Arthur Andersen was aware of past problems with the Company's methods in recording inter-company transactions. In 2000, Arthur Andersen identified two other financial risk areas: (i) the risk of credit defaults in residential and commercial accounts; and, (ii) continuous fluctuation in foreign currency causing a write-down in the Company's Embratel investment and potentially exposing the Company to further financial loss, or at least to fluctuating earnings that would have to be explained to analysts.

Since the Company was considered a maximum risk client, Arthur Andersen, pursuant to firm policy, was required to hold in each of the audit years an expanded risk discussion in order to discuss certain areas that created risk to Arthur Andersen. In general, the audit partners and managers associated with the WorldCom engagement participated in such discussions. The workpapers for audit years 1999 and 2000 reflect a number of troubling issues that were discussed by Arthur Andersen personnel during the expanded risk discussions. However, for the most part, Arthur Andersen concluded that other factors, including the integrity of the Company's Management, mitigated those risks. For some reason, it appears, based on certain correspondence in the workpapers, that the integrity of the Company's Management was rated as "low" at some point prior to 1999. It is unclear what caused such a rating or why that rating was changed to "good" in subsequent years. Disturbingly, no expanded risk discussion was documented in the workpapers for the 2001 audit year.

In particular, during the 1999 audit year, Arthur Andersen noted that the Company had potential to employ aggressively GAAP in a number of areas, including litigation reserves, tax reserves and purchase accounting, but concluded that its audit plan sufficiently addressed this risk and that, based on audit procedures performed, no material indications that Management was employing aggressive accounting were noted. It should be highlighted that these are all areas that are currently the subject of investigation and possible restatement or adjustment by the Company and its current external auditors. During the audit year 2000, Arthur Andersen noted that it had identified a number of potential fraud indicators in prior years in the area of purchase accounting, including aggressive accounting policies by Management, and Management pressures to maintain high stock valuations in anticipation of a security offering or merger while continuing to use the Company's stock as currency for transactions. Again, Arthur Andersen concluded that it had designed sufficient audit procedures, including frequent consultation with Management on purchase transactions by the Company, and that these risks were mitigated by the integrity and extensive M&A experience of Management.

Arthur Andersen also utilized, during all three audit years, a Fraud Risk Practice Aid to assess the risk of material fraud and accordingly plan and perform the audit in order to obtain reasonable assurance that any material fraud will be detected. As part of this process, Arthur Andersen assessed the Company's accounting policies as "aggressive" in 1999 but changed that assessment to "conservative" in 2000 and 2001.[123] The documents memorializing this process also refer to a number of areas that posed risks of material fraud, including pressure by the Company's Management to maintain high stock valuations in anticipation of a security offering or merger which could create the opportunity for earnings manipulations in the areas of purchase accounting entries, allowances for doubtful accounts, and the basic revenue process. During the 1999 audit, Arthur Andersen noted that the following Company practices might indicate a desire by Management to manipulate earnings: (i) highly aggressive accounting and disclosure

123 We have not identified any narrative explanation in the workpapers for this change.

practices; (ii) changes in accounting principles or accounting estimates, with questionable support; and (iii) inappropriate means to reduce taxable earnings.[124] During the 2000 audit, Arthur Andersen noted a risk for fraud created by the fact that all WorldCom employees were compensated by the issuance of stock options and that stock options were a significant portion of senior Management compensation. However, Arthur Andersen concluded that it would mitigate such risk by reviewing significant judgmental items such as allowances for bad debts, line cost accruals and legal reserves to ensure that Management was not intentionally misstating earnings in an attempt to bolster the stock price.

Finally, in a session among the Arthur Andersen participants of the 2001 audit, the auditors identified the following key financial statement fraud risks to be addressed in the audit:

- Misstatement of revenues through top-side adjustments;
- Improper capitalization of expenses as fixed assets;
- Manipulation of allowances for bad debts; and,
- Manipulation of purchase price adjustments and subsequent adjustments within the one year period.

Arthur Andersen was required to design its audit plan to provide reasonable assurance of detecting errors or irregularities. Yet, based upon the audit workpapers, Arthur Andersen does not appear to have completely designed procedures to address such concerns or even to have fully implemented those procedures it planned.

2. Deficiencies in Arthur Andersen's Performance of its Audits

While our investigation is ongoing, we have noted a number of areas relating to Arthur Andersen's performance of its WorldCom audits that raise questions, especially in light of the

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[124] These items were not noted as concerns during the audits for 2000 and 2001.

risks identified in connection with the planning process. Those areas relate to: (i) Arthur Andersen's apparent failure to plan and/or complete a number of important audit procedures that had been planned; (ii) the inappropriate influence of the Company's Management over the audit process; (iii) the faulty reliance on the integrity of the Company's Management; and (iv) the failure to communicate certain critical assessments and conclusions to the Audit Committee as well as to Company Management.

a. Arthur Andersen's Apparent Failure to Design Adequate Procedures or Perform Planned Procedures

Given Arthur Andersen's assessment of WorldCom as a maximum risk client and identification of concerns for the potential for earnings manipulation, as well as conflicting views of the integrity of the Company's Management, it was imperative that Arthur Andersen plan and perform adequate procedures that took such risks into consideration rather than relying on Management's representations. It does not appear, however, that Arthur Andersen properly designed and fully performed the procedures that it planned with respect to its audits of WorldCom for the years 1999, 2000 and 2001.

Based on its assessment of relevant risks, Arthur Andersen determined during the planning stages of the audits for years 1999, 2000 and 2001 that it should perform certain procedures, including the testing of controls and substantive tests, relating to a number of audit areas where there were higher risks of error, fraud or failure. For many financial statement line items, the substantive tests performed by Arthur Andersen were analytical in nature and, in certain situations, did not include reviewing underlying documentation. Instead, Arthur Andersen at times compared certain account balances to those in prior years or quarters and noted explanations provided by Management for any variances.

At times, however, certain planned procedures do not appear to have been performed. These procedures related to such matters as: control testing of certain revenue processes; reviews of significant top level adjustments related to 1999 line costs; FAS 121 impairment reviews related to fixed assets and goodwill; confirmation of debt; review of documentation related to the Information Technology Infrastructure; review of computations related to deferred tax assets; and, review of certain variance analyses related to liabilities. Of particular note, Arthur Andersen identified in its 1999 audit plan the need to provide special attention to significant top-level adjustments made by the Company to its financial statements relating to line costs. However, the 1999 workpapers that relate to line costs do not contain any evidence that Arthur Andersen performed any detailed procedure. Other examples of procedures that were planned, but whose performance was not documented, include procedures to test the realizability of goodwill balances, testing of controls related to purchase accounting entries, reviewing the computation of deferred tax assets, and reviewing any policies in place respecting impairment review of assets. Even if these planned procedures were indeed implemented, at the least, it is disturbing that the results of the testing were not documented.

At other times, it appears that Arthur Andersen's testing had significant flaws. For instance, Arthur Andersen reviewed the processes and controls relating to capital expenditures, using small samples to test the effectiveness of controls over the accounting of Construction in Progress projects. Such an approach would be effective only if all entries to fixed assets were made through the Company's normal purchasing process, but that was not the case. Moreover, in testing the controls in place relating to line costs and the calculation of expenses and related accruals, Arthur Andersen appears to have reviewed only MCI-related domestic line costs and not line costs attributed to the WorldCom group or the international divisions.

b. Management's Influence Over the Audits

We have identified a number of areas where Management appears to have inappropriately influenced the performance of Arthur Andersen's audits. Of equal concern is the apparent failure of Arthur Andersen's engagement team to have obtained access to the systems and information needed to properly perform its audits.

First, it appears that during the relevant audit years, Arthur Andersen was denied access to the Company's general ledgers and other ledgers and journals. We understand that, during its initial audits of the Company, Arthur Andersen was given computer-generated printouts of the general ledgers. Arthur Andersen's access to information from the general ledgers, however, was later terminated at some point during its audit relationship with the Company. It is unclear at this stage of our investigation who was involved in the decision to restrict the access of the external auditors. At the least, Arthur Andersen should have requested back-up tapes of the general ledgers. Moreover, there does not appear to be any evidence at this stage that Arthur Andersen ever complained about such limitations or, indeed, informed the Audit Committee that its access had been drastically restricted. Such restrictions are questionable even where an external auditor performed, as here, a risk-based audit. Such limitations on the scope of the audit should have, if significant, caused Arthur Andersen to consider modification of its audit opinions on the financial statements.

Second, Arthur Andersen appears to have fully coordinated with WorldCom's Management its annual audit workplans, including discussions about the adequacy of the relevant controls environment and the procedures performed related to of each area of testing. The Company's Controller and the Director of Financial Reporting and her staff acted as "gatekeepers" with respect to Arthur Andersen audit requests. They were the designated contacts for all requests by Arthur Andersen for information and documents. They also were supposed to review and approve all schedules prepared by WorldCom personnel in response to such requests before the information could be furnished to Arthur Andersen.

Arthur Andersen personnel appear to have accepted such limitations. Indeed, the engagement manager at one point specifically instructed his staff to conform with the Company's limitations because the Company was a high profile client and because the support of Management was important especially since the Company was contemplating a merger with Sprint and Sprint's external auditors would likely be competing to obtain the engagement for the WorldCom audit. When Arthur Andersen was replaced by KPMG as the Company's external auditors, a former Arthur Andersen engagement partner who had accepted a position as a partner at KPMG reassured Mr. Sullivan that he would continue to "monitor" the engagement "from a distance to make sure the engagement [was] conducted to [Mr. Sullivan's] satisfaction" even though he no longer participated on the engagement based on SEC rules requiring rotation from the engagement after 7 years. He reminded Mr. Sullivan that, in the past he had been able to "work" his reviewing partners "hard" in order to get "good" answers on accounting questions that needed to be reviewed by partners in Arthur Andersen's National practice office in Chicago. He committed to doing the same at KPMG once he got to know the KPMG team, and to eventually return to the engagement in two years as the "lead partner." KPMG categorically rejected these reassurances to Mr. Sullivan once the new KPMG engagement partner learned of them. The former Arthur Andersen partner is no longer with KPMG.

While the scope of audit work may be discussed by the external auditors with the Audit Committee and Management in general terms, it should be noted that detail procedures are to be determined by the auditors. The auditors should not be influenced by the client in determining or adjusting such procedures. Certain efficiencies may be gained by the auditor's funneling all information though designated Company personnel. However, such an approach could hinder the gathering of certain evidence that could be gained from discussions with accounting personnel at the locations at which the Arthur Andersen staff were performing their audit.

c. Unfounded Reliance on Integrity of Management and Fraudulent or Misleading Financial Reports

As noted, there are a number of disturbing instances of false or misleading reports that were generated by Company Management and provided to Arthur Andersen in response to its requests. Arthur Andersen's seemingly unquestioned reliance on the integrity of the Company's senior Management, as well as its failure to carry out substantive testing in areas that it admittedly identified as having significant risks of failure, fraud or error, resulted in an inexcusable acceptance of Management's representations.

The most glaring example of this is the preparation by WorldCom employees of a schedule of revenues during the third and fourth quarters of 2001 that was provided to Arthur Andersen but differed materially from an internal schedule that was circulated to Company senior Management during the same period. After the end of each quarter, as well as at the end of each month, employees of the Company's Revenue Accounting Department prepared a revenue report, known as the MonRev, that identified the revenues received by the Company during the previous month or quarter from all of its billing systems and sales channels, as well as from non-recurring sources such as settlements of customer disputes. The MonRev compared actual revenues to the budgeted numbers for those areas.

During the third and fourth quarters of 2001, in anticipation of questions being raised by Arthur Andersen over the increases in large amounts reflected in the "Corporate Unallocated" line and schedules from the prior quarters, a Special MonRev report was prepared for Arthur

Andersen that differed materially from the MonRev distributed to the Company's Management.[125]

d. Failure to Communicate Critical Assessments with Audit Committee and Senior Management

Arthur Andersen's apparent failure to communicate certain critical assessments and significant issues to the Audit Committee is also troubling. GAAS required Arthur Andersen to communicate certain matters directly to the Company's Audit Committee including, among other things, any significant changes to the Company's accounting policies, any disagreements with Management, any difficulties encountered during their audit, and any conditions which, in the auditor's judgment, represent significant deficiencies in the design or operation of internal controls which could adversely affect the organization's ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements. While Arthur Andersen provided periodic presentations to the Audit Committee that addressed a number of these areas, those presentations generally revolved around Arthur Andersen's conclusions that the Company's financial statements were fairly presented and in accordance with GAAP and that no material weaknesses to the Company's internal controls had been identified by Arthur Andersen as part of its audit.

As previously discussed, Arthur Andersen had stopped providing the Audit Committee with Management comment letters by 1998 at the latest. The last Management comment letter we have obtained and reviewed was dated in 1997 and related to Arthur Andersen's 1996 audit. It is unclear why and when Arthur Andersen actually ceased providing such letters to the Audit Committee. The workpapers for 1999 and 2000 reflect that Arthur Andersen provided

[125] Discussion of the "Special MonRev" report and other irregularities is covered in greater detail the Report of the Special Investigative Committee of the Board. In order to promote efficiencies and avoid duplication, the Examiner has not investigated in detail those matters.

memoranda documenting its comments to the Company's Controller and Director of Revenue Reporting. No such memorandum appears to have been provided by Arthur Andersen for 2001. It is clear, however, that no other reporting mechanism to the Audit Committee was substituted in place of the Management comment letter, though Arthur Andersen continued to make periodic presentations to the Committee regarding its audit plans and the overall conclusions of its audits.

Irrespective of the vehicle for such communications to the Audit Committee, clearly certain issues that were noted by Arthur Andersen should have been presented to the Audit Committee. There is no evidence that such communications were provided.

First, Arthur Andersen does not appear to have ever communicated its specific risk assessments to the Audit Committee. Discussions of risks at the Audit Committee meetings appear limited to descriptions by Arthur Andersen of those areas carrying greater audit risks with assurances that those areas would receive greater attention from the auditors. Second, Arthur Andersen does not appear to have informed the Audit Committee that it was restricted from accessing the Company's general ledger by Management or limited in any way with respect to the information it sought in connection with its audits. Third, Arthur Andersen identified a number of comments in 1999 and 2000 in its workpapers which it does not appear to have communicated to the Audit Committee, including that the Company should improve its controls relating to a number of areas. At one point, Arthur Andersen noted that one of the Company's divisions, Embratel, was unable to bill certain accounts aggregating significant amounts because of billing issues relating to unbillable calls. However, this does not appear to have been communicated to the Audit Committee.

Importantly, despite the fact that Arthur Andersen and Internal Audit both identified numerous weaknesses or deficiencies in the Company's internal controls, there appears to have been little discussion at the Audit Committee level of any such weaknesses, aside from some findings of the Internal Audit Department relating to particular audits they performed. Nor is there any evidence that Arthur Andersen informed the Audit Committee of its observations that Management had made unsupported journal entries to the ledgers of its United Kingdom subsidiary that were not corrected prior to the issuance of the financial statements.

While we have not yet determined why Arthur Andersen failed to communicate such findings to the Audit Committee, the absence of such communications, in addition to the other matters discussed above, raises troubling questions as to whether Arthur Andersen properly conducted its audits of the Company's financial statements for the years 1999, 2000 and 2001 in accordance with GAAS.

3. Additional Matters to be Invesigated

The Examiner is continuing his investigation of Arthur Andersen's conduct with respect to the WorldCom engagement and is attempting to obtain additional documents as well as conduct interviews of key members of the Arthur Andersen engagement team assigned to WorldCom. The Examiner will continue his review of work performed by Arthur Andersen in connection with the matters identified above, as well as any other appropriate matters that come to our attention.

E. The Examiner's Review of the Company's Ongoing Restatement Effort

In the accounting irregularities section of the Examiner's First Interim Report it was noted that in the 1999-2002 period deceptive accounting practices at WorldCom had "deteriorated into a concerted program of manipulation that gave rise to a smorgasbord of fraudulent journal entries and adjustments." As reflected by the criminal prosecution of WorldCom's senior financial Management, including its Chief Financial Officer, its Controller and its Director of General Accounting, among others, it is no surprise that the books and records of the Company at the time it filed for bankruptcy had been fundamentally corrupted as a result of the program of earnings manipulation.

As part of his mandate, the Examiner has reviewed the Company's restatement effort. In approaching this task, the Examiner was mindful of that portion of the Bankruptcy Court's July 22, 2002 enabling order that requires the Examiner to avoid unnecessary duplication of effort in connection with other agencies' and approved third party efforts involved in the post-bankruptcy affairs of the Company. Given the number of accounting personnel dedicated to the task within WorldCom and the personnel from KPMG engaged in the audit of the Company's 1999-2002 financial statements, the Examiner concluded that such an independent review would be duplicative and inefficient. Instead, the Examiner structured his review of the restatement process in an oversight mode. In addition, the Examiner recognizes and commends the work of the Corporate Monitor, the Honorable Richard C. Breeden, and is coordinating with the Corporate Monitor to avoid any duplication of effort or scope.

1. The Company's Restatement Process

WorldCom prepared a Process Memorandum for the Examiner that described the restatement process undertaken by the Company. The Process Memorandum described the creation of sub-controller positions for Revenue Accounting, Operational Accounting, External reporting, and Accounting Policies and Practices, and further noted that "[t]he Company consulted with KPMG in the development of this plan in order to most effectively leverage the Company's resources in supporting the current audit process." The Process Memorandum also stated that the Restatement Group was to be comprised of three separate teams—the Technical Review Team,[126] the Special Accounting Team[127] and the Audit Assist Team[128]. The Process

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[126] ***The Technical Review Team***: "to review major and complex business transactions and consider the propriety of the Company's historical accounting treatment…." Based on transaction data provided

Memorandum noted, "[all issues identified by the team would be investigated and should not have any limitation of scope or pre-determined materiality level." The teams were to be comprised of specially recruited accounting professionals and the Audit Committee of the Board of Directors was said to have been "periodically informed of progress made in developing [the restatement] framework."

The Company committed to incorporating into the restatement process as implemented by the three teams, the relevant work product of the Company's Ethics Committee, KPMG, PriceWaterhouseCoopers (the forensic accountants to the Special Investigative Committee of the Board of Directors), the Examiner and WorldCom's Internal Audit Department.

2. The Restatement Process in Action

a. Observation and Review by the Examiner.

On an ongoing basis commencing in December 2002, the Examiner's forensic accountants, J.H. Cohn LLP, have been in regular contact with senior financial Management of the Company, including those persons directly responsible for overseeing the implementation of

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by KPMG, the team began evaluating 25 business combinations, in addition to reviewing all transactions entered into with EDS and AOL and business relationships with the Company's top 10 vendors and customers.

127 ***The Special Accounting Team***: "to address known issues which included balancing of inter-company accounts, investigation of clearing accounts, examining prepaid expenses and accrued expenses." The Process Memorandum noted, however, that it was previously determined that "the restatement process needed to be resourced separately from the rebuilding of the accounting functions to support the day to day operations of the Company and from assisting KPMG in preparing for their three year audit." Particular priority was to be placed on the Special Accounting Team's focus on inter-company and clearing account reconciliations "because of the pervasive impact of these accounts on other issues being examined."

128 ***The Audit Assist Team***: "to have responsibility for specific tasks in support of KPMG's three year audit plan as well as the restatement project," as determined by and coordinated with KPMG. The Audit Assist Team was to provide certain technical assistance, as well, to the other teams "in accessing databases and providing detailed account accumulation needed by [such teams]."

the restatement process. Through these regular interactions, the Examiner has obtained an understanding of the various procedures utilized by the Company to identify potential restatement items and has monitored the progress of the overall restatement effort and of specific restatement items. The Examiner has also reviewed supporting documentation for all items deemed "completed," whether or not the Company's review resulted in a restatement adjustment.

On March 13, 2003, the Company announced its third restatement. It reported that it had completed a preliminary review of its goodwill and other intangible assets and property, plant and equipment ("PP&E") accounts. Under GAAP, companies are to evaluate on an on-going basis if long-lived and intangible assets have been permanently impaired whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Historically, the Company failed to do so and the Company's impairment review has resulted in the write-off of all existing goodwill and a substantial write-down of the carrying value of PP&E and other intangible assets aggregating $79.8 billion.[129] Specifics of the impairment adjustments include:

- The value of goodwill reflected on the Company's last reported balance sheet (March 31, 2002), $45 billion, is impaired and will be written off completely; and
- The value of PP&E and other intangible assets reflected on the Company's last reported balance sheet, $39.2 billion and $5.6 billion, respectively, is impaired and will be adjusted to a value of approximately $10 billion as of December 31, 2002.

b. Assessment of the Operation of the Restatement Teams.

It is apparent to the Examiner that the Company's intentions with respect to the restatement process as contained in the Process Memorandum were ambitious. While there is no

[129] The Examiner has requested a complete copy of the appraisal report and analytical back-up, but to date those materials have not been produced.

evidence that suggests a lack of effort or good faith, the inherent difficulties of the process hindered the Company's efforts to meet all of the commitments contained in the Process Memorandum.

The source of the problem appears to have been the sheer magnitude of accounting related tasks that needed to be addressed at the Company in the winter and early spring of 2003 and the limited resources available to research them adequately. We observed during this period what was, in essence, a triage process occurring at the Company, where priorities were established within the restatement teams (and between the restatement teams and other accounting personnel at the Company) such that less urgent and material matters were relegated to secondary status. The Examiner will continue to review the restatement process in accordance with his mandate.

3. Observations on the Monitoring Process and Issues for the Examiner's Future Attention

The Company has diligently addressed the truly Herculean task of evaluating for restatement WorldCom's financial statements for the three years of 1999-2002. However, the process has proven to be complex and difficult and the timing for completion of this project is uncertain. The Examiner will continue to monitor this process and report to the Court on it at a later date.

X. INVESTMENT BANKING

In the First Interim Report, the Examiner reported on a number of issues related to WorldCom's relationship with various investment banks. Since that time, the Examiner has continued his investigation into this area, including speaking to many witnesses and reviewing numerous documents. The Examiner is not in a position at this time to report further on issues related to WorldCom's relationship with investment banks and will report on additional findings and observations at a later date.

XI. CONCLUSION

In many significant respects, WorldCom appears to have represented the polar opposite of model corporate governance practices during the relevant period. Its culture was dominated by a strong Chief Executive Officer, who was given virtually unfettered discretion to commit vast amounts of shareholder resources and determine corporate direction without even the slightest scrutiny or meaningful deliberation or analysis by senior Management or the Board of Directors. The Board of Directors appears to have embraced suggestions by Mr. Ebbers without question or dissent, even under circumstances where its members now readily acknowledge they had significant misgivings regarding his recommended course of action. Moreover, the Directors unquestioningly complied with Mr. Ebbers' requests, even when it became apparent that his deteriorating personal financial situation imperiled the Company and greatly undermined their confidence in him.

Although the absence of internal controls and the lack of transparency between senior Management and the Board of Directors at WorldCom does not directly translate to the massive accounting fraud committed by the Company, the Examiner believes these corporate governance failings fostered an environment and culture that permitted the fraud to grow dramatically and ultimately propelled the Company's descent into bankruptcy. A culture and internal processes that discourage or implicitly forbid scrutiny and detailed questioning can be a breeding ground for fraudulent misdeeds. It also can beget ill-considered and wasteful acquisitions, improperly managed and unchecked debt and poor credit management, a lack of due diligence regarding personal loans made by the Company to its Chief Executive Officer, sales of Company stock by the Chief Executive Officer that contravene WorldCom policy and possibly the federal securities laws, and an effective neutering of other gatekeepers, such as the lawyers, Internal Audit Department and the Company's outside auditors. In tandem with the accounting irregularities, these developments fostered the illusion that WorldCom was more healthy and successful than it actually was throughout most of the relevant period. Ultimately, they also produced the largest bankruptcy in the history of the United States.

Our investigation regarding these and other matters is ongoing and many of our observations remain preliminary. We believe there is a great deal more to this story, particularly as it relates to the type and nature of the injuries sustained by the Debtors as a result of conduct by WorldCom Management and others. The Examiner will address these and related matters in a subsequent Report.

Respectfully submitted,
<u>/s/Dick Thornburgh</u>
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CompuServe/AOL/ANS Chronology

December 1996 – March 1997. Salomon, serving as investment banker for CompuServe Corp. ("CompuServe"), contacted 21 potential acquirers of CompuServe, which was then owned by H&R Block, Inc. and H&R Block Group, Inc. (collectively, "H&R Block"). WorldCom and America Online, Inc. ("AOL"), as well as nine other potential acquirers, met with Salomon and/or CompuServe management to explore a possible transaction. During this period, WorldCom evaluated its interest in acquiring CompuServe and concluded that it was interested in acquiring only CompuServe's network services business.

December 20, 1996. WorldCom conducted due diligence at CompuServe.

January 29, 1997. WorldCom conducted further due diligence at CompuServe.

February 20, 1997 – April 17, 1997. Representatives of AOL met with CompuServe management to conduct a due diligence review and subsequently made an offer to acquire CompuServe pursuant to a non-taxable transaction structure. Representatives of AOL, CompuServe, and H&R block entered into intensive negotiations to finalize the terms of the transaction and to prepare definitive documentation. On April 17, 1997, however, AOL's Board of Directors was informed that newly introduced federal legislation threatened the non-taxable transaction structure of its proposed CompuServe acquisition.

April 21, 1997. AOL abandoned its plans to acquire CompuServe.

May – July 1997. Salomon contacted WorldCom and other potential CompuServe acquirers to explore the possibility of an acquisition of CompuServe through a joint bid. Having concluded that AOL primarily was interested in acquiring CompuServe's interactive services business and that WorldCom primarily was interested in acquiring CompuServe's network services business, Salomon suggested to WorldCom that it contact AOL and other potential bidding partners to discuss a joint bid for CompuServe.

June 18, 1997. WorldCom conducted another due diligence review of CompuServe.

July 7 and 30, 1997. Representatives of WorldCom and AOL met to discuss a joint bid for CompuServe and agreed to continue considering such a transaction.

Early August 1997. WorldCom contacted Salomon to express interest in a possible acquisition of CompuServe in a stock-for-stock transaction.

August 12 and 13, 1997. WorldCom began due diligence review of AOL's wholly owned subsidiary, ANS Communications, Inc. ("ANS"), which provided Internet networking services primarily to AOL.

August 14, 1997. WorldCom, CompuServe and AOL entered into a confidentiality agreement relating to WorldCom's and AOL's potential acquisition of CompuServe.

September 2, 1997. Mr. Ebbers provided notice to the WorldCom Board that a special telephonic meeting would be held at 11:00 a.m. Eastern time on September 4, 1997. Along with the memorandum notifying the Board of this special meeting, Management provided to the Board:

(i) a one-page overview of CompuServe's network and interactive services divisions and the business of ANS;

(ii) a one-page summary of the complex transaction in which: (a) WorldCom would acquire CompuServe from H&R Block for $1.3 billion; (b) WorldCom would transfer CompuServe's interactive services division to AOL and pay AOL $175 million; (c) WorldCom would retain CompuServe's network services division; (d) WorldCom would acquire ANS from AOL for $500 million; and (e) WorldCom's new ANS and CompuServe network services subsidiaries, together with UUNET Technologies, Inc. ("UUNET"), would enter into a five-year contract with AOL to provide network capacity and services (collectively, the "AOL Transaction");

(iii) a two-page discussion of Management's reasons for entering into the AOL Transaction; and

(iv) CompuServe and ANS balance sheets, consolidated projected income statements, and projections concerning financial synergies.

September 4, 1997. Management convened a special telephonic WorldCom Board meeting. Mr. Sidgmore appears to have begun the September 4th Board meeting by providing background information on the Transaction. Mr. Ebbers then discussed financial aspects of the Transaction, and Mr. Cannada reviewed with the Board the memorandum that had been provided to the Board members prior to the meeting. Mr. Galesi appears to have raised a question concerning risks to the AOL Transaction posed by review under the Hart-Scott-Rodino Act and Mr. Sidgmore appears to have discussed financial aspects of the AOL Transaction that could cause it to be dilutive. Mr. Borghardt explained to the Board the various AOL Transaction agreements, the proposed Board resolutions, and the appointment of Steve Case to the WorldCom Board as a part of the AOL components of the deal. The Board meeting lasted for approximately one hour.

September 8, 1997. WorldCom publicly announced the AOL Transaction in a press release. Mr. Ebbers is quoted in this press release as follows:

We believe that these moves [comprising the AOL Transaction] further distance us from all of the traditional carriers, as we continue to build a different kind of communications company. . . . Following our successful merger with MFS and UUNET, this transaction underscores our belief that the communications marketplace has fundamentally changed. In this new world, customers are demanding increasingly advanced Internet and data networking services. These acquisitions will further strengthen and broaden our Internet business. This is a transaction which will contribute significantly to our revenue and growth and is expected to be accretive to earnings.

September 11, 1997. At its regular quarterly meeting, WorldCom's Board officially adopted the resolutions approving the AOL Transaction that it had adopted at its September 4^{th} meeting.

January 31, 1998. The AOL Transaction closed.

MCI Chronology

November 3, 1996. MCI Communications Corporation ("MCI") entered into an Agreement and Plan of Merger with British Telecommunications plc ("BT") and a subsidiary of BT, pursuant to which MCI would merge with BT Sub and the stockholders of MCI would receive stock of BT and cash in exchange for their MCI common stock.

August 21, 1997. MCI and BT entered into an amendment to the original BT/MCI Merger Agreement, which, among other things, reduced the per share consideration to be received by MCI stockholders in the planned merger. The implied per share value to MCI stockholders of the consideration contemplated by the BT/MCI Merger Agreement was approximately $30-$31 as of August 21, 1997. Shortly thereafter, a Salomon investment banker advised Mr. Sullivan, WorldCom's CFO, that the revision of the MCI/BT Merger Agreement might provide an acquisition opportunity for WorldCom.

September 11, 1997. During executive session, the WorldCom Board was advised that a hostile takeover bid for MCI might be possible and that Mr. Sullivan had already spoken with Salomon and lawyers at Cravath, Swain and Moore ("Cravath") about such a possibility.

September 25, 1997. Notice of Special WorldCom Board meeting for September 29, 1997.

September 29, 1997. Special WorldCom Board meeting to consider the MCI bid, as well as the Brooks Fiber acquisition. Attended by Salomon, Cravath and MacKensie. Special Committee comprised of Messrs. Sullivan, Bobbitt, Jaros and Tucker is appointed. Various documents re transaction are reported to be provided to the Board.

September 30, 1997. Special Committee meets and approves the proposed transaction, advised by Management, Salomon and Cravath.

October 1, 1997. WorldCom publicly announced, and delivered a letter to MCI, confirming its intention to commence an exchange offer to acquire all the outstanding shares of MCI Capital Stock for $41.50 of WorldCom Common Stock per share of MCI Capital Stock.

October 15, 1997. GTE publicly announced, and delivered a letter to MCI, confirming, its willingness to offer $40.00 in cash for each share of MCI Capital Stock.

October 28 through October 31, 1997. Representatives of MCI and WorldCom and their respective financial and legal advisors met in New York and Mississippi to participate in due diligence presentations concerning WorldCom, the original WorldCom offer and the potential cost savings contemplated by the original WorldCom offer.

Week of November 3, 1997. Representatives of WorldCom and MCI and their respective financial advisors discussed and exchanged certain nonpublic information concerning the two companies. As a result of these discussions and exchanges of information, the WorldCom representatives concluded that there were significant new areas of potential cost savings that could be achieved in a merger of MCI and WorldCom that had not been previously identified.

Week of November 3, 1997. Representatives of WorldCom and its advisors had discussions with representatives of BT and its advisors, during which discussions the representatives of BT requested to receive cash for BT's interest in MCI and the parties discussed certain other issues, including termination of the BT/MCI Merger Agreement.

November 5, 1997. WorldCom's financial advisers contacted MCI's financial advisers to discuss the possibility of increasing WorldCom's then current proposal in order to secure MCI's approval.

November 7, 1997. After the close of the market, Mr. Ebbers telephoned Mr. Roberts and indicated that WorldCom would be prepared to increase its offer to $50.00 per share of MCI common stock and MCI Class A Common Stock, which offer was based on the expectation that the boards of the two companies would meet to consider the offer prior to the opening of the markets on Monday, November 10. Mr. Ebbers indicated that, in consideration for BT's cooperation and willingness to agree to certain restrictions, WorldCom would be prepared to pay a premium for the shares of MCI Class A Common Stock held by BT.

November 9, 1997. Mr. Lee met briefly with Mr. Roberts and delivered a letter indicating that GTE was preparing to increase its offer above $45.00 in cash per share of MCI Capital Stock if it were given more time to conduct additional due diligence.

November 9, 1997. The negotiations between WorldCom and BT concluded, with WorldCom agreeing to pay BT cash for its shares of MCI Class A Common Stock and BT agreeing, among other things, to vote in favor of the MCI/WorldCom Merger and against any competing transaction.

Evening of November 9, 1997. The WorldCom Board met to consider the potential merger with MCI. At this meeting, Management of WorldCom, as well as WorldCom's legal and financial advisers, made presentations regarding their due diligence findings concerning MCI, the terms of the definitive agreement discussed by WorldCom and MCI, and the BT Agreement, and Salomon rendered an oral opinion to the WorldCom Board to the effect that the consideration then proposed to be paid pursuant to the proposed MCI/WorldCom Merger Agreement was fair to WorldCom from a financial point of view. The WorldCom Board then unanimously approved and authorized the execution and delivery of the MCI/WorldCom Merger Agreement and BT Agreement. In addition, at the November 9 meeting, the WorldCom Board established a subcommittee consisting of Messrs. Ebbers, Sidgmore and Sullivan and delegated to the WorldCom Subcommittee the authority to establish the exact pricing terms of the MCI/WC Merger, if different from those discussed and approved by the WorldCom Board.

Later that evening. The WorldCom Subcommittee met to consider the final pricing terms of the MCI/WorldCom Merger. Salomon rendered an oral opinion (subsequently confirmed in writing) to the effect that the consideration to be paid pursuant to the MCI/WorldCom Merger Agreement to the holders of MCI Common Stock and MCI Class A Common Stock was fair to WorldCom from a financial point of view. Based upon the presentations and discussions at the full WorldCom Board meeting, the developments since the full WorldCom Board meeting and the opinion of Salomon rendered to the WorldCom Subcommittee, the WorldCom Subcommittee approved the final pricing terms set forth in the MCI/WorldCom Merger Agreement.

Evening of November 9, 1997. The MCI Board met to consider the proposed MCI/WorldCom Merger. Mr. Roberts reported on his conversations with Mr. Lee earlier that day, and the terms of the letter received from GTE were discussed with the MCI Board.

The MCI Board meeting was adjourned while Mr. Roberts telephoned Mr. Ebbers and requested that the consideration to be received by MCI stockholders in the proposed MCI/WorldCom Merger be increased. During their conversation, Mr. Ebbers agreed (subject to the approval of the WorldCom Subcommittee) to increase the consideration to $51.00 of WorldCom Common Stock (subject to adjustment based on the WorldCom Average Trading Price during the Measurement Period).

Subsequently, Mr. Roberts reported to the MCI Board on his conversation with Mr. Ebbers. After discussion and consideration, the MCI Board unanimously reconfirmed, based on the final pricing terms, its approval of the MCI/WorldCom Merger, Agreement, the BT Agreement and the transactions contemplated thereby.

Later that evening, the WorldCom Subcommittee met to consider the final pricing terms of the MCI/WorldCom Merger. Salomon rendered an oral opinion (subsequently confirmed in writing) to the effect that the consideration to be paid pursuant to the MCI/WorldCom Merger Agreement to the holders of MCI Common Stock and MCI Class A Common Stock was fair to WorldCom from a financial point of view. Based upon the presentations and discussions at the full WorldCom Board meeting, the developments since the full WorldCom Board meeting and the opinion of Salomon rendered to the WorldCom Subcommittee, the WorldCom Subcommittee approved the final pricing terms set forth in the MCI/WorldCom Merger Agreement.

After the requisite approvals were obtained from the BT Board of Directors, on November 9, 1997, the BT Agreement was executed, the MCI/WorldCom Merger Agreement was executed and the BT/MCI Merger Agreement was terminated.

September 14, 1998. The MCI/WorldCom merger closed.

EDS Chronology

November 13, 1998. Mr. Borghardt sent a confidentiality agreement between WorldCom and Electronic Data Systems Corporation ("EDS") via email to Messrs. Sullivan, Cannada, and others.

November 19, 1998. Messrs. Sidgmore and Cannada reported to the WorldCom Board on the possibility of a sale of MCI Systemshouse L.L.C. ("SHL") and entering into some outsourcing agreements, including possibly with EDS.

December 15, 1998. The Washington Post reported that WorldCom and EDS were in talks to form a joint venture that would provide a broad array of voice, data, and computer systems services to global business customers. WorldCom would turn over management of its internal billing and information systems to EDS; thousands of WorldCom employees would go to work for EDS; EDS was reported to be considering purchasing part of WorldCom's business of creating complex computer systems for clients; and WorldCom would handle the communications needs of EDS customers.

December 28, 1998. Mr. Borghardt was on a conference call with WorldCom outside counsel regarding drafts of the proposed EDS agreements, which were dated as early as December 7.

February 9, 1999. Mr. Sidgmore prepares a draft memorandum for the WorldCom Board, explaining the proposed agreements with EDS. This memorandum was not provided to the Board.

February 10, 1999. Simpson Thatcher & Bartlett fax to Mr. Borghardt, with attached memo from the law firm to the WorldCom Board explaining proposed agreements with EDS. This memorandum was not provided to the Board.

February 10, 1999. From 5:00 PM to 5:20 PM, Management convened an informational call with the WorldCom Board. Using his draft memo, Mr. Sidgmore explained the proposed transactions:

- Sale of SHL to EDS for $1.65 billion;
- EDS outsources voice and data services to WorldCom for 10 years, with revenues estimated at $6-8.5 billion.
- WorldCom outsources information technology services to EDS for 10 years, with revenues estimated at $5-7 billion.
- EDS and WorldCom will enter into a joint marketing agreement.

Board members seem pleased with proposed agreements during call, and someone says at the end "will proceed." No Board vote taken during informational call.

Late February 10 - early February 11, 1999. WorldCom and EDS execute Framework Agreement committing to the transactions.

February 11, 1999. WorldCom announces EDS agreements, as well as fourth quarter 1998 earnings results.

March 3 - March 4, 1999 WorldCom Board Meeting. Mr. Ebbers reported on the transactions with EDS, as to which the Board had previously been informed. The Board resolved to approve the agreements and any and all actions by WorldCom to complete the transactions. There appears to have been no substantive discussion of the EDS transactions at the Board meeting and no documents appear to have been provided prior to or at the meeting.

April 1999. WorldCom completed the sale of SHL to EDS for $1.6 billion.

October 1999. WorldCom and EDS finalized the dual outsourcing agreements. In connection with the EDS agreement to be WorldCom's IT outsourcer, approximately 1,300

WorldCom employees were transferred to EDS. In connection with WorldCom's agreement to be EDS' network outsourcer, approximately 1,000 EDS employees will eventually transfer to WorldCom.

Nextel Chronology

November 19, 1998, WorldCom Board Meeting. Mf. Sidgmore identifies wireless as a strategic objective over the next 1-2 years.

Winter 1999. WorldCom commences research on Nextel Communications, Inc. ("Nextel").

March 3-4, 1999. WorldCom regular Board meeting. During executive session, a potential Nextel acquisition is discussed, with Mr. Sidgmore, and two other Directors in favor of Nextel as a good entry into wireless and Mr. Sullivan and one other Director likely opposed due to Nextel's heavy debt load and possibly for other reasons as well. Rest of Board is undecided. Board decides that Management should continue to explore a possible transaction, although it does not endorse either "side."

March 12, 1999. WorldCom and Nextel execute a nondisclosure agreement in connection with WorldCom's evaluation of Nextel.

April 6 – 9, 1999. Nextel provides to WorldCom various due diligence materials.

April 7, 1999. SSB hosts a WorldCom due diligence session regarding Nextel at Jones Day's D.C. office. WorldCom attendees include Messrs. C. Cannada, C. DeCell, B. Finch, B. Grothe, D. Myers, S. Patel, J. Renna, B. Borghardt, M. Kloeppel and R. Shah.

April 10, 1999. Mr. Borghardt reviews draft of Nextel valuation summary.

April 12, 1999. Mr. Grubman of SSB leaves voice message for Sullivan telling him that major investors do not want WorldCom to do the Nextel deal.

Approximately April 26, 1999. Mr. Grubman states in a public message: "And as far as NEXTEL is concerned, I guess the only thing we would say is Bernie and Scott, as well as their advisors are not stupid, and if it makes sense to do, it'll be done. If it doesn't, it won't. And one thing you can take to the bank, that if a deal is done, it would be financially prudent thing to do, or else it won't happen."

April 27-30, 1999. WorldCom continues Nextel due diligence process.

April 29, 1999. Cravath provides comments to Mr. Borghardt on Nextel draft fairness opinion prepared by SSB.

April 30, 1999. Mr. Salsbury provides to Mr. Grothe a one-page status memorandum on Nextel due diligence efforts.

May 4, 1999. Ms. Kloeppel provides Mr. Sullivan a draft engagement letter from SSB in connection with the possible Nextel merger.

On or about May 6, 1999. Mr. Sidgmore understands Mr. Ebbers now favors a Nextel deal and Mr. Sidgmore has a handshake deal with Nextel, with all material terms negotiated.

May 6, 1999. WorldCom issues press release announcing that it will not pursue a Nextel combination at this time. Mr. Sidgmore recalls an abrupt call from Mr. Ebbers telling him the Nextel deal is off. Mr. Sullivan persuaded Mr. Ebbers to kill the deal and threatened to leave WorldCom if the Nextel deal were approved.

May 20, 1999. WorldCom regular Board meeting. Board minutes do not mention Nextel. Mr. Sidgmore believes he may have been approached privately by certain Directors but that Nextel was not addressed in the actual meeting.

SkyTel Chronology

Summer of 1998. Representatives of SkyTel Communications, Inc. ("SkyTel"), including Mr. Palmer, SkyTel Chairman, and Mr. Stupka, SkyTel CEO, hold informal discussions with various telecom companies believed to be interested in discussing possible strategic transactions with SkyTel. SkyTel consults with Warburg Dillon Read as part of the ongoing review of strategic alternatives.

Early February 1999. Discussions between WorldCom and SkyTel (initiated by Mr. Palmer), in which Mr. Ebbers acknowledges that WorldCom internally considered pursuing a negotiated business combination transaction with SkyTel. Mr. Ebbers requests that SkyTel contact Mr. Cannada (WorldCom Sr. VP, Corp. Dev.) regarding the matter.

February 14, 1999. Mr. Grothe (WorldCom VP, Corp. Dev.) gives Mr. Cannada a SkyTel valuation model in review of a potential business combination.

February 18-25, 1999. Mr. Leonard Kriss (SkyTel Sr. VP and GC) and Mr. Bruce Borghardt (WorldCom GC, Corp. Dev.) negotiate a nondisclosure agreement between SkyTel and WorldCom.

February 25, 1999. SkyTel and WorldCom execute confidentiality agreement.

February 26, 1999. SkyTel furnishes to WorldCom first round of SkyTel's financial and operating information and business plans.

March 3-4, 1999. Regular quarterly WorldCom Board meeting. A potential SkyTel transaction was mentioned by Mr. Cannada to the Board on March 4, during an executive session. Board is told a SkyTel transaction is being considered in conjunction with a much more strategic entry into the wireless business, i.e., the possible Nextel transaction.

March 18, 1999. WorldCom sends SkyTel questions regarding SkyTel's business.

March 23, 1999. SkyTel senior executives (including Messrs. Palmer and Stupka) meet with WorldCom representatives to review SkyTel's business and prospects. SkyTel makes a presentation to WorldCom, followed by a question and answer session. Mr. Stupka informs Mr. Cannada that SkyTel is willing to begin preliminary discussions concerning a possible business combination.

March 30, 1999. Mr. Cannada sends Messrs. Ebbers and Sullivan a memorandum summarizing SkyTel discussions. Reports on disappointing fourth quarter 1998 results and states that a SkyTel acquisition would not be strategic absent other wireless acquisitions.

April 5, 1999. WorldCom and SkyTel representatives (Messrs. Cannada and Stupka, respectively) meet to discuss a possible business combination. Mr. Cannada advises Mr. Stupka that WorldCom is interested in pursuing discussions only if WorldCom reaches a definitive agreement with another possible merger candidate (Nextel) in the wireless segment with which it is conducting preliminary discussions.

April 5, 1999. WorldCom's due diligence checklist distributed to internal due diligence team members for review and input.

April 8, 1999. WorldCom consults Cravath attorneys regarding WorldCom's interest in acquiring SkyTel.

April 8-13, 1999. WorldCom representatives and WorldCom legal (Cravath) and accounting advisors (Arthur Andersen) review SkyTel due diligence documents in the Washington, D.C. office of SkyTel's outside counsel, Jones Day. WorldCom conducts telephone interview of SkyTel employees regarding due diligence issues.

April 12, 1999. WorldCom (Messrs. Grothe and Cannada), SkyTel (Messrs. Stupka and Ferguson) and Dillon Read meet to discuss certain SkyTel financial information and to share the SkyTel Board's reaction to the proposed transaction's price range.

April 12, 1999. Cravath distributes initial drafts of Merger Agreement and Stock Merger Agreement to WorldCom, SkyTel and Jones Day.

April 15, 1999. WorldCom executives discuss the status of the SkyTel deal and whether to proceed with the transaction. Messrs. Ebbers, Cannada and Grothe agree that no definitive action will be taken regarding SkyTel at this time.

Mid- to late April. Negotiating teams from SkyTel and WorldCom discuss possible specific transaction terms (including pooling-of-interests and deal completion) and conduct additional due diligence.

May 6, 1999. WorldCom (Mr. Cannada) informs SkyTel (Mr. Stupka) that WorldCom has terminated discussions with Nextel, but that, notwithstanding this development, WorldCom is now considering a SkyTel combination independently.

May 13, 1999. Messrs. Grothe and DeCell prepare file memorandum re SkyTel pertaining to lackluster results the last two quarters and forecasts for the future.

May 19, 1999. A document entitled "SkyTel: Company Description," is prepared by Corporate Development, with a handwritten note from Michele Kloeppel that it was "for WorldCom Board."

May 20, 1999. Regular quarterly WorldCom Board meeting. Mr. Cannada reportedly made a brief (15 minute) presentation regarding SkyTel to the Board during executive session. The Board took no vote but authorized WorldCom Management to proceed with the transaction at its discretion. The total SkyTel discussion was described as "minimal." The May 19, 1999 document may have been used by Mr. Cannada but Directors did not get a copy of it. It does not appear that other data, such as the May 13, 1999 file memo, were provided. It also does not appear that the Board was advised of SkyTel's poor results in recent quarters or that WorldCom Management viewed this as a "mediocre" deal.

May 25, 1999. Discussions between WorldCom and SkyTel representatives. SkyTel requests restructuring exchange ratio to protect shareholders in event of a WorldCom stock decline. WorldCom agrees to increase exchange ratio to 0.25 (to a minimum of $72/share of WorldCom stock) only in exchange for termination fee and stock option at implied merger price.

May 25, 1999. Cravath distributes revised Merger Agreement to WorldCom, SkyTel and Jones Day based on telephone conferences with Messrs. Borghardt and Grothe and earlier comments received from Jones Day.

May 25, 1999. Messrs. Cannada and Grothe meet with Mr. Ebbers to discuss the status of SkyTel negotiations.

May 25-May 28. WorldCom and SkyTel representatives complete due diligence and negotiations.

May 28, 1999. SkyTel Board approves the WorldCom merger following an oral fairness opinion by Warburg Dillon Read (subsequently confirmed in writing).

May 28, 1999. WorldCom and SkyTel enter into Agreement and Plan of Merger. Cravath distributes execution copies of related agreements to WorldCom, SkyTel and Jones Day and signature pages are exchanged.

May 28, 1999. Messrs. Ebbers and Palmer announce the transaction and conduct a joint press conference.

June 4, 1999. Mr. Borghardt circulates via e-mail to Management a draft Written Consent resolution by which WorldCom's Directors would approve the WorldCom-SkyTel merger.

June 16, 1999. Mr. Borghardt again circulates via e-mail to Management a draft Written Consent resolution by which WorldCom's Directors would approve the WorldCom-SkyTel merger.

After June 16, 1999. WorldCom Directors execute a Written Consent resolution approving the WorldCom/SkyTel merger. It does not appear that Directors were informed of final merger terms or provided any documents besides the Written Consent.

September 9, 1999. Regular quarterly WorldCom Board meeting. Board minutes indicate update by Scott Sullivan to the Board on the SkyTel transaction. Mr. Sullivan reported that the SkyTel merger would result in a charge against WorldCom's earnings in 1999 but would be accretive in 2000. Board unanimously adopted additional resolutions pertaining to the SkyTel merger.

September 29, 1999. Special meeting of SkyTel shareholders to approve WorldCom merger.

October 1, 1999. SkyTel merger completed.

Intermedia Chronology

March 2, 2000. At the quarterly WorldCom Board meeting, Mr. Sidgmore recommended that WorldCom investigate becoming a player in the managed web hosting business, by investigating a joint venture with Andersen Consulting. He had gotten favorable views from Goldman Sachs regarding such a venture.

May 17, 2000. Goldman Sachs sends Mr. Sidgmore a draft engagement letter to act as WorldCom's adviser on the Andersen Consulting joint venture matter.

June 1, 2000. At the quarterly WorldCom Board meeting, Mr. Sidgmore again addresses the idea of a joint venture ("Jaguar") with Andersen Consulting in the managed web hosting business. The Board approves the joint venture, subject to Management working out issues. Digex, Inc. ("Digex") is mentioned in the context of being a potential competitor of the joint venture. No discussion of any attempt to acquire Digex or any other entity in the managed web hosting business. The Jaguar joint venture approach would have been a relatively cost-free method for WorldCom to get into managed Web hosting.

June-late August, 2000. WorldCom conducts extensive investigation of the Jaguar joint venture proposal and negotiates with Andersen Consulting concerning the potential Jaguar joint venture.

Early July 2000. WorldCom's Corporate Development Department is contacted by Bear Stearns to determine if WorldCom has any interest in a business combination with Intermedia Communications, Inc. ("Intermedia") or Digex. Intermedia owns sufficient Digex stock to have control of Digex.

July 11, 2000. Intermedia announces it has retained Bear Stearns to explore strategic alternatives. Bear Stearns develops information packages for Intermedia and Digex.

Late July/early August, 2000. WorldCom personnel prepare analyses about various web hosting firms, including Digex.

August 3, 2000. WorldCom receives the Bear Stearns information packages for Digex and Intermedia. WorldCom contacts Bear Stearns but discussions did not proceed.

Mid-August, 2000. WorldCom pursues web hosting discussions with Global Center and WorldCom personnel travel to California in connection with a possible transaction.

August 30, 2000. WorldCom is scheduled to meet with Global Center on August 31 in Jackson, Mississippi. When Global Center seeks to put off the meeting for a week, Messrs. Grothe and Ebbers become suspicious and later learn Global Center is pursuing Digex. This reportedly angers Mr. Ebbers, who then decides that WorldCom will explore acquiring Digex and/or Intermedia.

August 30, 2000 (PM). WorldCom representative called Intermedia to express interest in acquiring Digex. WorldCom was told that given other discussions, an agreement must be reached by 5:00 p.m. Sept. 1, 2000.

August 31 (PM). WorldCom negotiating team (Messrs. Stupka, Grothe, Renna, Behm, Coakley, Briggs, Beaumont and Ferro) meets with outside counsel and principals of Intermedia in New York and later with Digex principals, starting about 1:30 PM. Total business due diligence on August 31 is estimated to have lasted about 1.5 hours, with no documents changing hands. No legal due diligence at all.

Late afternoon August 31. WorldCom advised Bear Stearns that WorldCom now wanted to acquire Intermedia and leave Digex a publicly traded subsidiary. Discussions of price of $39/share plus need for a Section 203 waiver. Offer made at $39/share.

Late afternoon August 31, 2000. Chase Securities, Inc. ("Chase") hired to be WorldCom's financial adviser. Replaces SSB as adviser due to a SSB conflict.

Early September 1, 2000. Corporate Development advises Mr. Sullivan in several e-mails that it estimates the cost of the deal (in terms of stock issued and debt assumed) to be just over $6 billion and that Intermedia's non-Digex assets are worth about $1.457 billion.

Late morning September 1, 2000. Chase provides Mr. Sullivan certain financial analyses re Intermedia and Digex. One graph in the Chase analyses suggests a possible value of Intermedia's non-Digex assets of $3.1 to 3.5 billion.

September 1. Digex Board, via a 4-3 vote, approved the Section 203 waiver. All of Digex's independent directors opposed the waiver but they are out voted by the Intermedia directors on the Digex Board.

September 1. Intermedia Board approved the WorldCom merger, after getting an oral Bear Stearns fairness opinion (later put in writing).

September 1, 2000, 2:00 PM. Mr. Sidgmore receives notification via telephone from Mr. Ebbers of a 3:30 p.m. Board meeting to consider an Intermedia transaction. Mr. Sidgmore was in Florida at the time. He had no prior knowledge that such a transaction was being considered. He advised Mr. Ebbers that he did not favor such a transaction and that a joint venture like Jaguar could get WorldCom into managed web hosting for far less cost. Mr. Ebbers informed Mr. Sidgmore that he thought the transaction made sense even at the much higher price.

September 1. WorldCom Board meets via telephone, starting at 3:30 PM Eastern time. The meeting lasts 35 minutes. WorldCom representatives and their advisers describe the deal to the Board, which then approved it unanimously. WorldCom advisers at the meeting were from

Chase and Cravath. Ebbers reported to have led the discussion, along with Messrs. Stupka, Beaumont, and Briggs, and Sullivan, as well as representatives from Cravath and Chase Securities. Main purpose of the merger with Intermedia was to gain a controlling interest in Digex. WorldCom to issue about $3 billion in stock and assume about $3 billion of Intermedia debt. Intermedia assets to be sold for around $3 billion (according to Mr. Sullivan) and for possibly $3-3.5 billion (according to Chase). No evidence that any documents were provided. The transaction was described as having taken place at "warp speed." No one informed the WorldCom Board of its obligation to become informed of all relevant facts.

<u>September 1, 2000</u>. Intermedia and WorldCom execute merger at about 5:00 p.m.

<u>September 5, 2000</u>. Merger publicly announced.

<u>September 6, 2000</u>. Corporate Development document sent to Messrs. Sullivan, Stupka, Grothe, Bingham, Myers and Arthur Andersen. Values cost of the transaction at $5.575 billion; assumes Intermedia non-Digex assets are sold for $1.9 billion.

<u>September 7</u>. Regular quarterly WorldCom Board meeting. Intermedia discussed by Messrs. Beaumont, Stupka, Ebbers, Sullivan and Salsbury, including a report that Digex minority stockholders have commenced litigation over the Section 203 waiver. One Director asks if there are any buyers in sight for the Intermedia non-Digex assets, to which the reply is that some calls have been made. A focus is on the fact that a successful asset sale will permit a paydown on the Intermedia debt.

<u>September 8, 2000</u>. News report that the vote of the Digex Board on September 1 on the Section 203 waiver was 4-3, with the interested Intermedia directors all in favor and all the independent directors opposed. A special committee of the independent directors had

recommended a "no" vote. Commentators state that it is very rare for a special committee recommendation to be rejected.

September 12, 2000. Chase estimates for Management that the Intermedia non-Digex assets can be sold for between $2.0 and 2.7 billion.

September 20, 2000. Chase prepares Confidential Information Package for sale of Intermedia's non-Digex assets.

October 31, 2000. WorldCom guarantees Intermedia obligations under a revolving credit agreement up to $350 million.

Fall 2000. Market for CLEC assets, such as those held by Intermedia, took a nose dive.

November 16, 2000. WorldCom agrees with DOJ via a consent decree to divest all Intermedia assets, except for the Digex stock.

November 16, 2000. At the quarterly WorldCom Board meeting, there is an Intermedia report covering the DOJ consent decree and the Digex litigation. Lack of progress in the sale of the Intermedia assets is reported. It is reported by Mr. Salsbury that most people believe that the Digex minority shareholders will not prevail in the litigation. It does not appear that the declining value of Intermedia's CLEC assets was mentioned.

November 22, 2000. Goldman Sachs advises Scott Sullivan that the price being paid to acquire Digex via a takeover of Intermedia is quite high and inquires whether it can be adjusted.

November 28, 2000. Chase reports that efforts to find buyers for the Intermedia assets have not succeeded, due to the difficult market.

December 13, 2000. Delaware Chancery Court issues ruling in the Digex litigation. Court does not enjoin the transaction but indicates that Digex minority shareholders are likely to succeed on their claim that defendants had usurped a Digex corporate opportunity. News article on 12/14/00 states that damages could be as high as $2.5 billion. WorldCom took the position that the Court ruling and other matters (such as decline in value of Intermedia's assets) entitled it to refuse to complete the merger.

December 18, 2000. Intermedia shareholders vote to approve the merger.

December 18, 2000. WorldCom advised Intermedia that the validity of the Section 203 waiver was a necessary condition to completion of the merger.

Late December, 2000 – early February, 2000. Extensive negotiations concerning resolution of the Digex lawsuit, commercial deals with Digex and an amendment to the merger agreement.

February 12, 2001. A memorandum of understanding to resolve the Digex litigation, as well as an amendment to the Intermedia merger agreement, have been negotiated. The terms of the agreement including the following:

- A settlement of the Digex litigation, requiring a $15 million WorldCom payment and issuance of $165 million of WorldCom stock to a Digex minority shareholders settlement fund;
- An agreement between WorldCom and Digex to enter into a series of commercial arrangements, as well as an agreement after the completion of the Intermedia merger to fund Digex's business plans for 2001 and 2002, with the funding amount to be as much as $900 million; and
- An amendment to the WorldCom/Intermedia merger agreement, reducing the exchange ratio to one share of WorldCom stock for each share of Intermedia stock and changing other terms so that it would be much more difficult for

WorldCom to walk from the transaction if Intermedia's financial fortunes were to worsen further, as they subsequently did.

The cost to WorldCom of the overall transaction, not including the funding of Digex in 2001-02, was estimated as of February 15, 2001 to be $4.215 billion.

February 12, 2001. A Cravath lawyer sends WorldCom a draft Written Consent by which the WorldCom Board would be requested to approve the memorandum of understanding to resolve the litigation, the amendment to the merger agreement, and the commercial agreements with Digex.

February 13, 2001. Mr. Borghardt sends Mr. Salsbury a revised draft of the Written Consent, stating that once Mr. Salsbury approves, he will get Mr. Ebbers' comments and then route it to the Directors.

February 14, 2001. Mr. Behm informs Mr. Salsbury that a Chase update on the attempted sale of the Intermedia assets shows the best possible bids appear in the range of $800 million to $1.8 billion.

February 14, 2001. Mr. Salsbury is reported to have informed Mr. Sullivan's assistant that the Intermedia agreements need to be signed that day and he wants to know if Mr. Sullivan or Mr. Ebbers wants to sign in New York or whether Mr. Salsbury can sign them.

February 14 or 15, 2001. First amendment to the Intermedia's merger agreement is executed by Mr. Salsbury on WorldCom's behalf.

February 15, 2001. WorldCom issues press release announcing Digex settlement, stating that it has been approved by WorldCom's Board. The subsequently issued WorldCom registration statement on Form S-4 stated that the WorldCom Board approved the amended merger agreement on February 14, 2001.

February 16, 2001. The Wall Street Journal reports on the Digex settlement and the execution of the amended WorldCom/Intermedia merger agreement.

February 16, 2001. Mr. Salsbury and Mr. Borghardt exchange e-mails discussing whether the effective date for the Written Consent by the WorldCom Board to the amended WorldCom/Intermedia merger agreement should be February 15, 2001. Mr. Salsbury comments that the only document executed as of February 16, 2001 was the amendment to the merger agreement.

February 21, 2001. Mr. Borghardt reports to Mr. Sullivan's assistant that Mr. Ebbers has still not approved the Written Consent by which the WorldCom Board would be asked to approve the WorldCom/Intermedia merger amendment.

February 27, 2001. Mr. Sullivan reports to Mr. Hamilton that Chase has been unable to sell the Intermedia assets and that SSB has been engaged to help in the effort.

February 27, 2001. Chase reports to WorldCom that efforts to sell the Intermedia assets have been unsuccessful and that "Intermedia's performance continues to deteriorate. . . . .." Chase estimates that WorldCom's Intermedia funding could total $599 million in 2001.

March 1, 2001. WorldCom's Board at the March 1, 2001 quarterly meeting is presented with a Written Consent to approve the Digex settlement, the amended merger agreement and the Digex commercial transactions. No data is provided to the Board in advance of the meeting and a single slide by Mr. Salsbury describes the terms of the settlement and amended merger agreement. No member of the Board objected to Management having already signed the amended merger agreement. No data provided as to the possible value of the Intermedia assets. Several members of the Board viewed the transaction as a mistake and one spoke to Mr. Ebbers in private about it.

May 14, 2001. Intermedia reports that there have been continuing changes in Intermedia's financial condition and business and a continued general downturn in the markets where Intermedia did business. Intermedia also reports that as of yearend 2000, E&Y had expressed uncertainty as to Intermedia's ability to continue as a going concern.

May 14, 2001. Second amendment to merger agreement. Agreed merger would become effective July 1, 2001, subject to conditions being satisfied or waived.

June 11, 2001. WorldCom learns that Digex performance is behind plan. Revenues $40 million less than plan and net income $20 million less.

July 1, 2001. WorldCom/Intermedia merger closes. No fairness opinion.

October 30, 2001. E&Y provided WorldCom a Fair Value analysis of the tangible and intangible assets of Intermedia and Digex as of 6/30/01, which valuation was to be used for financial reporting purposes. This E&Y analysis suggests that the various assets, including intangibles other than goodwill, had a value of under $1 billion. That means that around $5 billion of the consideration was posted as goodwill.

2001 WorldCom 10-K. WorldCom reports that the Intermedia merger cost approximately $5.8 billion.

WorldCom Tracker Stock Chronology

March 2, 2000. WorldCom Board briefly discussed the possibility of creating Tracker stocks. No decisions were made.

March 2000. WorldCom Management evaluates restructuring options, including Tracker Stocks and has discussions with J.P. Morgan Securities, Inc. ("J.P. Morgan") and SSB.

June 12, 2000. SSB "Discussion Materials" for WorldCom, including review of separation alternatives.

July 12, 2000. SSB materials entitled "Project Gilbert: Spin-off and Tracking Stock Considerations," sent to Messrs. Ebbers and Sullivan.

August 3, 2000. Messrs. Salsbury and Nagel communicate about restructuring alternatives and possible regulatory issues.

Late August 2000. Mr. Grubman of SSB informed a WorldCom Investor Relations representative that he favored a spin off over the Tracker stocks.

September 7, 2000. WorldCom Board discussed the Tracker stock concept in detail at the executive session of a quarterly WorldCom Board meeting. The Board discussed three restructuring options: selling the consumer unit; spinning off the consumer unit; and creating the Tracker stocks. The discussion opened with Mr. Ebbers commenting that "all analysts talk about restructuring [but there was] no unanimity." No documents presented (besides slides) and no investment bankers were present. On several occasions, persons referred to the potential Tracker stocks as "financial engineering" and one Director questioned whether the Tracker stocks would create value or whether they were "just engineering." Several Board members indicated a preference for a spinoff or a sale of the consumer business but were told by in-house counsel that each of those options had regulatory problems, although in response to a further question, in-house counsel stated he was not an expert on spinoff regulatory issues and the nature of any such issues was not addressed. From concluding comments by Mr. Ebbers ("have to get it done; making rounds of investor conferences"), he seems to have believed there was a consensus in favor of the Tracker approach although no vote was taken. One Director was opposed to the Tracker but his opposition is not noted in the notes of the executive session.

September 18, 2000. SSB presentation entitled "Summary Review of Precedent Tracking Stock Recapitalizations." No indication of who received this document.

September 28, 2000. SSB presentation entitled "Observations and Considerations for Tracking Stock Issuance." This document was made available to WorldCom Management.

September 29, 2000. SSB presentation entitled "Observations and Considerations for Tracking Stock Issuance - Revised." No indication of who received this document.

September 29, 2000. SSB presentation entitled "Supplementary Valuation Materials." No indication of who received this document.

October 2, 2000. J.P. Morgan document entitled "Restructuring Discussions follow-up."

October 4, 2000. SSB presentation entitled "Tracking Stock Considerations." No indication of who received this document.

October 5, 2000. SSB presentation entitled "Tracking Stock Considerations." No indication of who received this document.

October 9, 2000. SSB presentation entitled "Dividend Policy Analysis." No indication of who received this document.

October 11, 2000. WorldCom engaged two financial advisers on Tracker issues, SSB and J.P. Morgan Securities, Inc., each of whom eventually were paid $3.5 million on Tracker work.

October 11, 2000. Mr. Sullivan sends WorldCom Directors "Form S-4 Signature Pages related to the Intermedia merger and project Tracker."

October 19, 2000. SSB presentation entitled “Potential Investor Questions.” No indication of who received this document.

October 29, 2000. SSB presentation entitled “Trackco Financial Models: $6 BN Debt Scenarios.” No indication of who received this document.

October 30, 2000. Mr. Ebbers noticed an “information call” of the WorldCom Board for October 31, 2000, at 5:00 p.m.

October 30, 2000. WorldCom scheduled an analyst conference for November 1, 2000.

October 31, 2000. WorldCom Management, SSB and Chase meet in New York to rehearse for November 1, 2000 analyst conference. Messrs. Sullivan and Ebbers announce to the attendees that new financial guidance needs to be issued.

October 31, 2000, 5:00 p.m. WorldCom Management convened an “information call” with the WorldCom Board lasting 15-30 minutes. SSB and Chase were not present for the call. Mr. Ebbers stated that on the next day, the two Tracking stocks (WorldCom Group and MCI Group) would be announced and that WorldCom would also announce new, negative financial guidance. Most of the call was devoted to the new financial guidance. No Board vote to approve the Tracker stocks was taken that day, although some interviewees believe that there was a consensus in favor and Board members knew of and did not object to the impending announcement.

November 1, 2000. WorldCom stated in a press release that the WorldCom Board had approved the Tracker Plan. On the same day, WorldCom announced new negative guidance.

November 16, 2000. WorldCom Board is reported to have continued discussions relating to the Tracker stocks.

December 1, 2000. Mr. Borghardt offered to assist Mr. Salsbury with minutes for the October 31, 2000 meeting. Mr. Salsbury informed Mr. Borghardt that the call was informational only.

January 5, 2001. Mr. Salsbury confirmed to Mr. Borghardt that the October 31, 2000 call was an information call.

January 31-February 1, 2001. After Mr. Borghardt conferred with Mr. Sullivan, it is decided to convert the October 31, 2000 information call to a special Board meeting, complete with resolutions and a Tracker Stock Policy Statement.

March 1, 2001. The Board minutes, including Tracker Stock resolutions and The Tracker Stock Policy Statement, for a now "official" Board meeting on October 31, 2000, are approved by the WorldCom Board without apparent comment.

June 2001. The Tracker stocks are approved by WorldCom shareholders.

Ebbers' Loan and Guaranty Chronology

Date	Event
1994	WorldCom extends a multi-million loan to Mr. Ebbers, who faced margin calls at the time. It is repaid in full within four to five months.
May 1998	Mr. Ebbers purchases a shipyard in Savannah, Georgia for approximately $14 million.
July 1998	Mr. Ebbers purchases the Douglas Lake ranch in British Columbia, Canada. Mr. Ebbers obtained a $40 million loan to purchase the property, and later valued it at over $100 million Cdn.
September 1999	Mr. Ebbers begins to purchase timberland (cumulatively named Joshua Timberlands) in various Southern states. The total purchase price for the properties was $658 million.
September 6, 2000	Mr. Ebbers owns approximately 19.4 million shares of WorldCom stock, with a value of approximately $611 million. All of this stock has been pledged to secure various loans, including approximately loans amounts from the following lenders: Bank of America ($ 310 million), CitiGroup ($52 million), PaineWebber ($65 million), and Morgan Keegan ($13 million).
September 6, 2000	Mr. Ebbers faces margin calls from Bank of America. Because the Board of Director's Compensation Committee feels that the sale of Mr. Ebbers' stock to pay his debts would have a likely adverse impact on the Company's already depressed stock price, the Committee agrees it is in the best interests of the Company and its shareholders to loan Mr. Ebbers $50 million. At the same meeting, the Committee decided to pay Mr. Ebbers' entire $10 million retention bonus in cash, although other employees received their retention bonuses in a combination of cash and stock.
September 7, 2000	At the Board of Directors' regular quarterly meeting, the Compensation Committee offers no report and never mentions the $50 million loan it had provided to Mr. Ebbers the day prior.
September 8, 2000	A promissory note dated as of September 8, 2000, but not drafted until November 2000, states that Mr. Ebbers promises to pay WorldCom $50 million on demand at the normal rate (fluctuating rate of interest equal to the Eurodollar Rate applicable to each one-month interest period plus the applicable margin) or the default rate.
September 28, 2000	Mr. Ebbers faces additional margin calls and seeks an additional loan. Mr. Kellett, Chairman of the Compensation Committee, refuses the loan request.
September 28, 2000	Mr. Ebbers enters into a forward sale contract with Bank of

	America for the sale of $3 million shares of WorldCom stock for approximately $70 million. When the sale is publicly announced on or about October 5, 2000, WorldCom's stock value drops $2.25 in one day, though it is not possible to determine if the Ebbers' sale was the cause of the fall.
October 20, 2000	Mr. Ebbers and two Compensation Committee members, Messrs. Bobbitt and Tucker, meet with representatives of Bank of America to try to convince them to take a security interest in Mr. Ebbers' non-WorldCom assets. Bank of America eventually refuses Mr. Ebbers' non-WorldCom assets as collateral but accepts a WorldCom guaranty in connection with its agreement to forbear from additional margin calls on Mr. Ebbers' debt.
October 27, 2000	Due to additional margin calls faced by Mr. Ebbers, the Compensation Committee decides it is in the Company's and its shareholders' best interests to provide an additional $25 million loan to him and a $75 million guaranty in favor of Bank of America. Bank of America agrees to forbear from exercising its rights on Mr. Ebbers' margin debt in return. The Compensation Committee's minutes state that Mr. Ebbers signed a letter agreement with WorldCom regarding the same. That letter agreement was not dated until November 1, 2000.
October 31, 2000	At a Special Meeting of the WorldCom Board of Directors, the Compensation Committee makes no mention of the loans and guaranty offered to Mr. Ebbers.
November 1, 2000	A promissory note dated as of November 1, 2000 states that Mr. Ebbers promises to pay WorldCom $25 million on demand at the normal rate or the default rate.
November 1, 2000	A Limited Guaranty dated as of November 1, 2000 states that WorldCom extended a $75 million unconditional guaranty to induce Bank of America to extend credit to the account of Mr. Ebbers.
November 1, 2000	In a letter to Mr. Ebbers dated November 1, 2000, Stiles Kellett, the Compensation Committee's chair, confirms an agreement whereby WorldCom will provide a Limited Guaranty to Bank of America with regard to his liabilities to the Bank. In addition, Mr. Ebbers agrees to indemnify WorldCom and to grant the Company a security interest in the shares of WorldCom stock he owns, subordinate to the rights of his other lenders.
November 13, 2000	The Compensation Committee increased the guaranty in favor of Bank of America to $100 million because it is in the best interests of the Company and its shareholders. During the forbearance period, Mr. Ebbers' obligation to the bank is considered reduced by the WorldCom guaranty.
November 14, 2000	A Limited Guaranty dated November 14, 2000 is offered to Bank of America to guarantee $100 million of Mr. Ebbers' debt.
November 14, 2000	WorldCom's third quarter 10-Q discloses the $75 million in loans

	and $100 million guaranty to Mr. Ebbers as of November 2000.
November 16, 2000	The Board of Directors meets for its quarterly meeting. Mr. Kellett gives the Compensation Committee's report, stating that, as a result of the pressure on the Company's stock, margin calls faced by Mr. Ebbers and other considerations, the Committee determined that it was in the best interests of the Company and its shareholders to loan funds to Mr. Ebbers and guarantee certain of his indebtedness in order to avoid additional forced sales of his stock. Mr. Kellett describes the terms of the loans and guaranty and references the inclusion in the Company's Form 10-Q of disclosures in that regard. Mr. Ebbers notes that the idea for the loans and guaranty had originated with the Committee and explains that, while he agrees that the actions were in the best interests of the Company and its shareholders, they are not necessarily in his best interests. With Mr. Ebbers abstaining, the Board unanimously ratifies and approves the loan and guaranty made by the Company.
December 6, 2000	In a letter, Mr. Ebbers authorizes Bank of America to disclose to the Compensation Committee "information concerning the relationship between the Bank and Mr. Ebbers and the Ebbers Entities."
December 27, 2000	The Compensation Committee determines that, because Mr. Ebbers faced additional margin calls that were going to exhaust the funds available under the existing loan arrangements, it would increase the loan to Mr. Ebbers by an additional $25 million.
December 29, 2000	A promissory note dated December 29, 2000 states that Mr. Ebbers promises to pay WorldCom $25 million on demand at the normal rate or the default rate.
January 30, 2001	The Compensation Committee discusses Mr. Ebbers' outstanding loan balance and approves a new replacement guaranty for up to $150 million plus "certain additional payments" because it is in the best interests of the Company and its shareholders.
February 12, 2001	As a condition precedent to Bank of America's refinancing of Mr. Ebbers' debt, WorldCom executes a new replacement Limited Guaranty. The new guaranty states that WorldCom agreed to guarantee the full payment by Mr. Ebbers of "any loans by Bank of America, any obligations of Ebbers to Bank of America for letters of credit or agreements with respect thereto, any drafts or any obligations of Ebbers to Bank of America for acceptances or agreements with respect thereto, including all interest and other charges stated therein, any other loans, promissory notes, advances or over advances payable by Ebbers to Bank of America, including all interest and other charges stated therein, all obligations of Ebbers to Bank of America under any guaranty, security agreement, instrument of lien, security deed or

	other security device in favor of Bank of America, and all other obligations of Ebbers to Bank of America however and whenever incurred or evidenced."
March 1, 2001	The Board of Directors meets again for its quarterly meeting. During that meeting, Mike Salsbury, WorldCom's General Counsel, reports on a demand by Harbor Finance Partners that legal action be taken on behalf of the Company against the Directors in connection with the loans and a guaranty made by the Company in favor of Mr. Ebbers. Following discussion, Mr. Kellett and Mr. Bobbitt provide additional information on the loans and guaranty, including additional amounts loaned or available to be loaned to Mr. Ebbers and the new guaranty approved by the Compensation Committee subsequent to the Board's November 16, 2000 meeting. The Board then unanimously ratified the additional loan and guaranty.
September 10, 2001	A promissory note dated as of September 10, 2001 states that Mr. Ebbers promises to pay WorldCom all amounts paid by WorldCom under the Limited Guaranty dated February 12, 2001. The applicable interest rate is either the normal rate or the default rate.
September 11, 2001	At the Board of Director's quarterly meeting on September 11, 2001, Mr. Kellett informs the Board that the Committee continues to review the status of loans to Mr. Ebbers and related documentation.
January 25, 2002	In connection with amendments to the loan documents between Mr. Ebbers and his related entities and Bank of America, the Compensation Committee determines that a proposed extension and modification of the guaranty arrangements with Bank of America is in the best interests of the Company and its shareholders. A First Modification and Reaffirmation of Limited Guaranty dated as of January 25, 2002 provides that WorldCom will also collateralize a letter of credit extended by Bank of America to Mr. Ebbers to support financing for Mississippi College. A later Pledge Agreement between WorldCom and Bank of America dated as of February 5, 2002 provides that WorldCom would grant a security interest in a brokerage account maintained by Bank of America to secure the letter of credit. In addition, the Committee approves an additional $65 million loan to Mr. Ebbers. Apparently, this loan was never ratified and approved by the full Board of Directors.
January 30, 2002	A promissory note dated January 30, 2002 states that Mr. Ebbers promises to pay WorldCom $65 million upon demand. Interest is based on the normal rate or the default rate
January, February 2002	Because WorldCom's share price fell below certain agreed upon amounts by February 2002, WorldCom paid out hundreds of millions of dollars in connection with its guaranty of Mr. Ebbers'

	debt to Bank of America. Consequently, Bank of America releases Mr. Ebbers' WorldCom stock that had served as collateral to WorldCom. WorldCom did not perfect its interest in this stock until March and April 2002.
February 28, 2002	Letter from Bruce Borghardt, counsel to the Compensation Committee, to the Committee members transmitting information regarding Mr. Ebbers' assets. Documents containing information regarding Mr. Ebbers' total debt load may have been communicated prior, but no transmittals of financial information to the Committee regarding Mr. Ebbers' assets before this date have been located.
March 5, 2002	Mr. Ebbers' financial statement dated as of December 31, 2001, showing Mr. Ebbers' estimated net worth to be $295 million. The Compensation Committee receives this statement later in March 2002.
April 1, 2002	The Compensation Committee decides that a new letter agreement with Mr. Ebbers pertaining to the loan and guaranty arrangements was in the best interests of the Company and its shareholders.
April 2, 2002	A letter from Mr. Kellett to Mr. Ebbers amends the understanding contained in the November 1, 2000 letter agreement regarding Mr. Ebbers' various contractual arrangements with WorldCom, including the guaranty and the five promissory notes. Mr. Ebbers agrees to indemnify WorldCom and pledge a security interest in all of his WorldCom shares other than those currently the subject of pledges for the benefit of Citibank and Bank of America until they are released, or later acquired pursuant to stock options. Because a portion of Mr. Ebbers' shares of WorldCom stock had been released from prior liens, the pledge is perfected as to 9,287,277 shares of WorldCom group stock and 575,149 shares of MCI group stock. In that letter, Mr. Ebbers also affirms that the December 31, 2001 financial statement he provided to the Company is correct and agrees to provide the Company information with respect to his interests in the Canadian ranch, the timber farm, and the shipyard.
April 17, 2002	Letter agreements dated April 17, 2002 between Mr. Ebbers' timber farm, his shipyard, and his Canadian ranch, and WorldCom, confirm that Mr. Ebbers granted to WorldCom a security interest in his ownership interests of those assets.
April 18, 2002	Pursuant to the letter agreement between Mr. Ebbers and WorldCom dated as of April 2, 2002, Mr. Ebbers' Pledge and Security Agreement in favor of WorldCom, Inc. grants a security interest in the available interests of his shipyard, his timber farm and his Canadian ranch.
April 29, 2002	A promissory note between Mr. Ebbers and WorldCom dated as of April 29, 2002 restates and replaces promissory notes dated

	September 8, 2000 ($50 million), November 1, 2000 ($25 million), December 29, 2000 ($25 million), September 10, 2001 (guaranty), and January 30, 2002 ($65 million). Mr. Ebbers promises to pay $408,214,930 plus the amount of any payments later made by WorldCom under the guaranty. Payment dates were established, starting April 29, 2003. The interest rate established was equal to the Eurodollar Rate.
April 29, 2002	Mr. Ebbers resigns as CEO of WorldCom.
April 29, 2003	Mr. Ebbers fails to make his first payment on his debt to WorldCom as provided by the April 29, 2002 promissory note. Mr. Ebbers is currently in default of his WorldCom loan agreement.